TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

JULY 10 AND 12, 1990

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TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES

TUESDAY, JULY 10, 1990

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearings follows:]

FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 27, 1990

PRESS RELEASE: #31
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES AND RELATED ISSUES

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold hearings on tax underpayments by U.S. subsidiaries of foreign companies and other related compliance issues. The hearings will be held on Tuesday, July 10, 1990, and Thursday, July 12, 1990, in the main Committee hearing room, 1100 Longworth House Office Building. The hearing on Tuesday, July 10, will begin at 9:30 a.m., and the hearing on Thursday, July 12, will begin at 11:00 a.m.

During the past year, the Oversight Subcommittee has vigorously investigated compliance with U.S. tax laws by U.S. subsidiaries of foreign-owned companies, as part of the Subcommittee's continuing review of various components of the $100 billion annual "tax gap". At these hearings, the Subcommittee will review overall compliance with section 482 of the Internal Revenue Code and focus specifically on foreign-owned distributors of automobiles, motorcycles, and electronics equipment. In addition, the Subcommittee will consider related issues involving the U.S. Customs Service and the Department of Commerce.

The Subcommittee will receive testimony from representatives of the Department of the Treasury, the Internal Revenue Service, the U.S. Customs Service, the Department of Commerce, Subcommittee staff investigators, tax and economic experts in the field, and other invited witnesses. The Subcommittee will go into closed executive session for a portion of the hearing on Tuesday, July 10, to receive nondisclosable testimony from IRS field agents regarding their actual experiences in examining U.S. subsidiaries of foreign-owned companies.

In announcing these hearings, Chairman Pickle stated: "During the last nine months, the Subcommittee has been examining noncompliance by U.S. subsidiaries of foreign-owned companies to determine whether and the extent to which these firms are underpaying corporate income taxes in the United States, how it is being done, and the extent to which other Federal laws under the Committee's jurisdiction have been violated. This investigation involved extensive review and analyses of IRS records, corporate income tax returns and information filed by foreign-owned subsidiaries, and other sources.

"At the hearing, I plan to lay out the facts and let them speak for themselves. While the tax issues involved are very complex, I believe that the fundamentals at issue are very simple. If certain foreign-owned companies operating in the U.S. are 'gaming' the Federal Treasury, the Congress should know how it is being done. While testimony at the hearing will need to be quite extensive and detailed, I think that the facts about what has and is going on should be comprehensively revealed."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Because the oral testimony at the hearing will be presented by invited witnesses only, interested parties are encouraged to provide written statements to the Committee for the printed hearing record. Persons submitting written comments should submit six (6) copies by the close of business, Friday, August 3, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The Chair will ask the subcommittee to please come to order.

Good morning to all of you. I have an opening statement.

Mr. Schulze has an opening statement and some of the members may have one too, and then we will go to our first witness.

For the past 9 months the Subcommittee on Oversight has been investigating noncompliance by U.S. subsidiaries of foreign-owned companies, focusing primarily on companies engaged in the automobile, motorcycle, and electronics equipment distributor industries. The purpose of the subcommittee's investigation is to determine the extent to which such firms are underpaying Federal income taxes in the United States, how some are able to reduce their U.S. tax payments to little or zero, and whether the IRS is on top of this important matter.

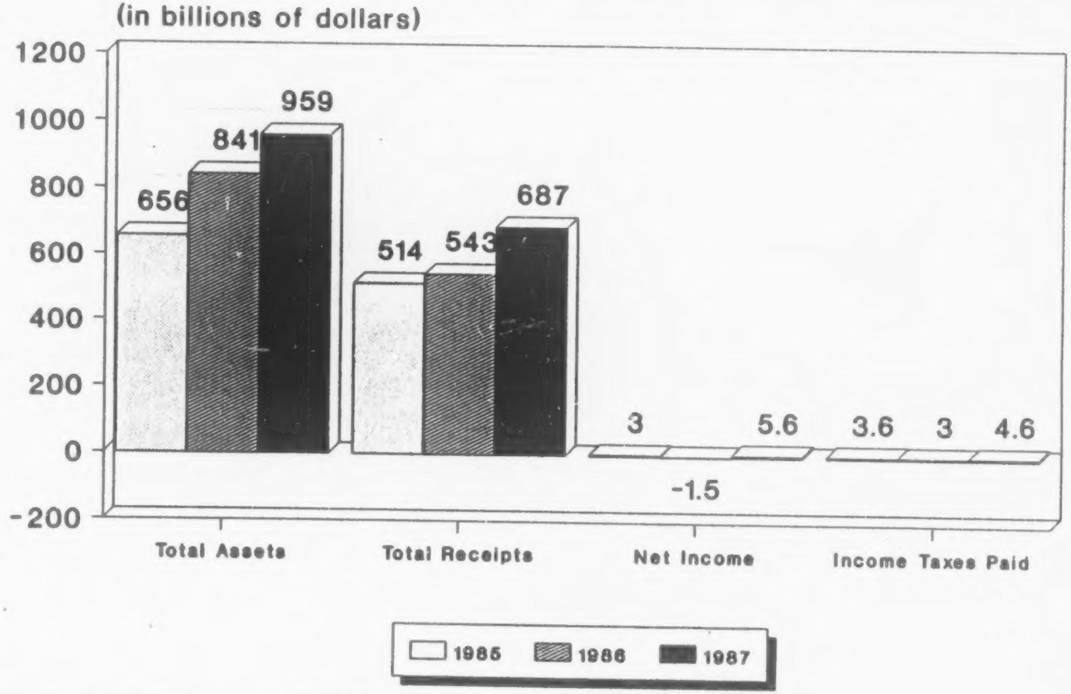
This subcommittee investigation is part of the subcommittee's continuing review of various components of the $100 billion tax gap, or the amount lost each year due to taxpayer noncompliance. The subcommittee will continue to review different aspects of the tax gap involving both corporate and individual taxpayer issues. The specific purpose of today's hearing is to set the record straight on whether the foreign-controlled U.S. companies the subcommittee reviewed have paid the amount of taxes our Federal tax laws require. We intend to lay the facts out for the record, and let them speak for themselves.

Foreign-controlled companies in the United States send billions of dollars worth of products to the United States each year for purchase by American consumers. The IRS reports that over a 5-year period, total receipts of U.S. subsidiaries under Japanese corporate control exceeded $644 billion. Over the same period, subsidiaries controlled by corporations from the United Kingdom follow with total receipts of over $400 billion. Consequently, I think it is not only fair, but part of the subcommittee's oversight responsibilities, that we ask whether these and other foreign-controlled subsidiaries in the United States are complying with our tax laws. In other words, are they paying the proper amount of taxes on these amounts.

Earlier this year, the IRS Commissioner defended the agency's aggressive examination of foreign-owned subsidiaries by pointing out that 1986 IRS statistics of income (SOI) data showed that foreign-owned companies reported approximately $550 billion in gross sales and a negative taxable income of $1.5 billion. The subcommittee requested and received more comprehensive SOI data from the IRS, through 1987, and the data were broken down by country and by certain industry groups. This information is attached to my statement for inclusion in the hearing record and will be discussed by the IRS Commissioner today.

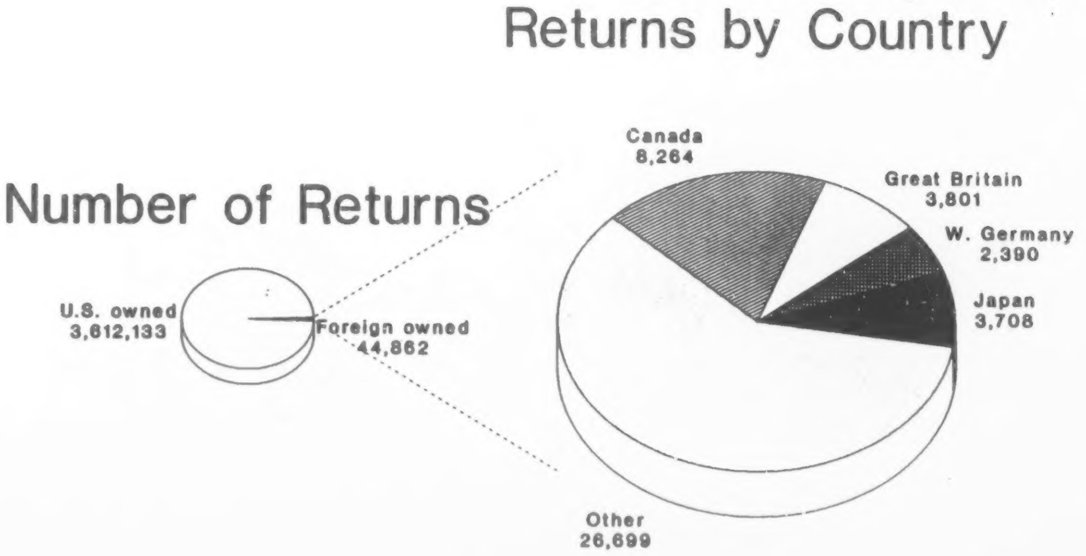
[The information follows:]

Foreign-Controlled U.S. Corporations
1985-1987



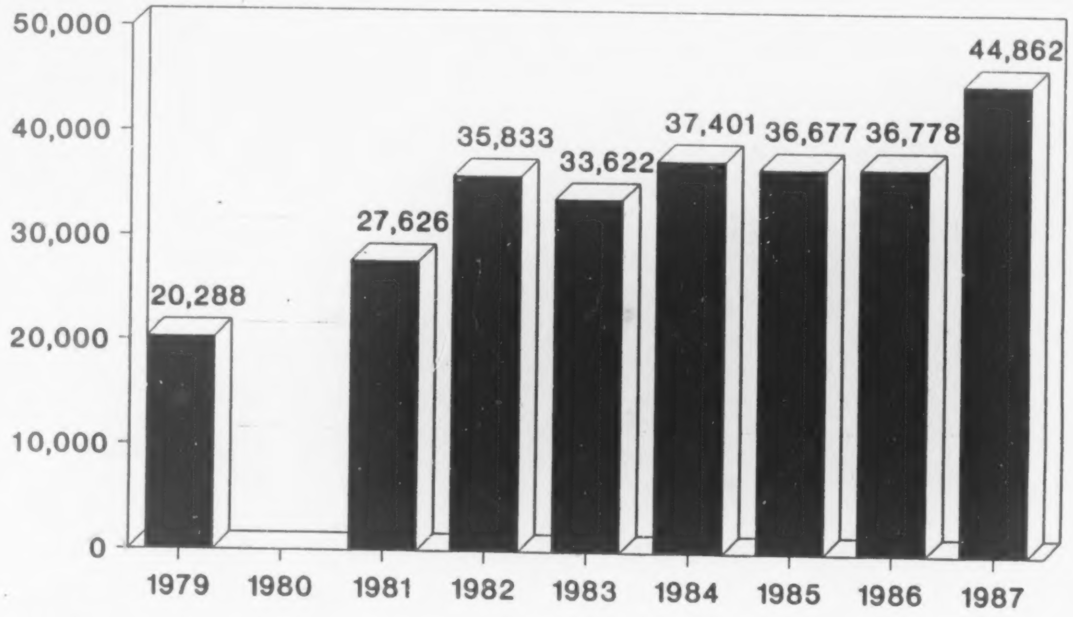
Source: Internal Revenue Service

U.S. & Foreign-Controlled
U.S. Corporations



Source: Internal Revenue Service

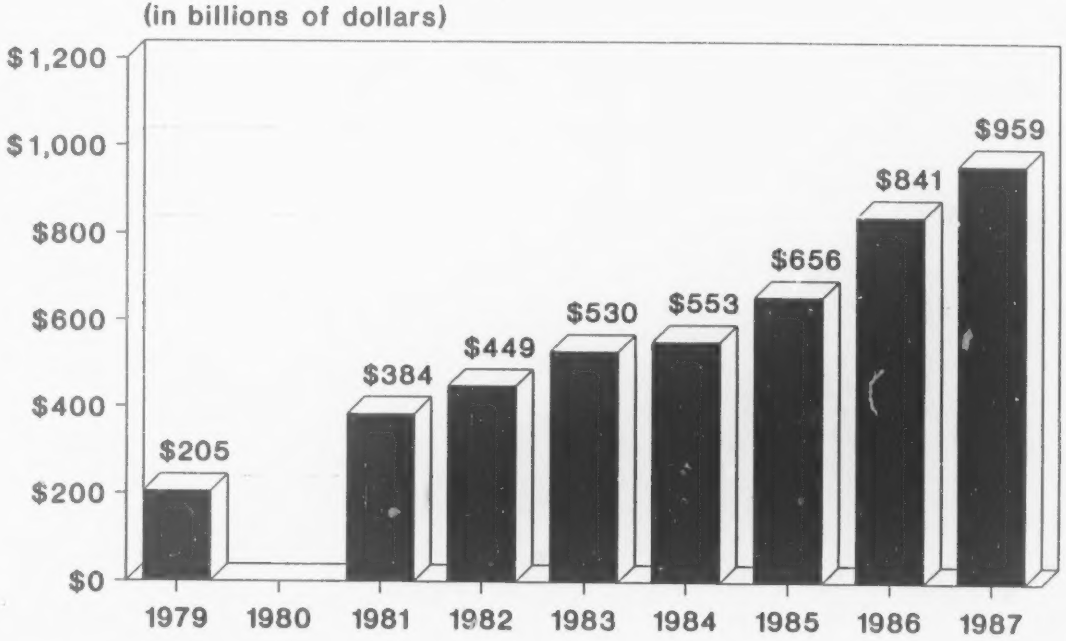
Foreign-Controlled U.S. Corporations
Number of Returns



Source: Internal Revenue Service

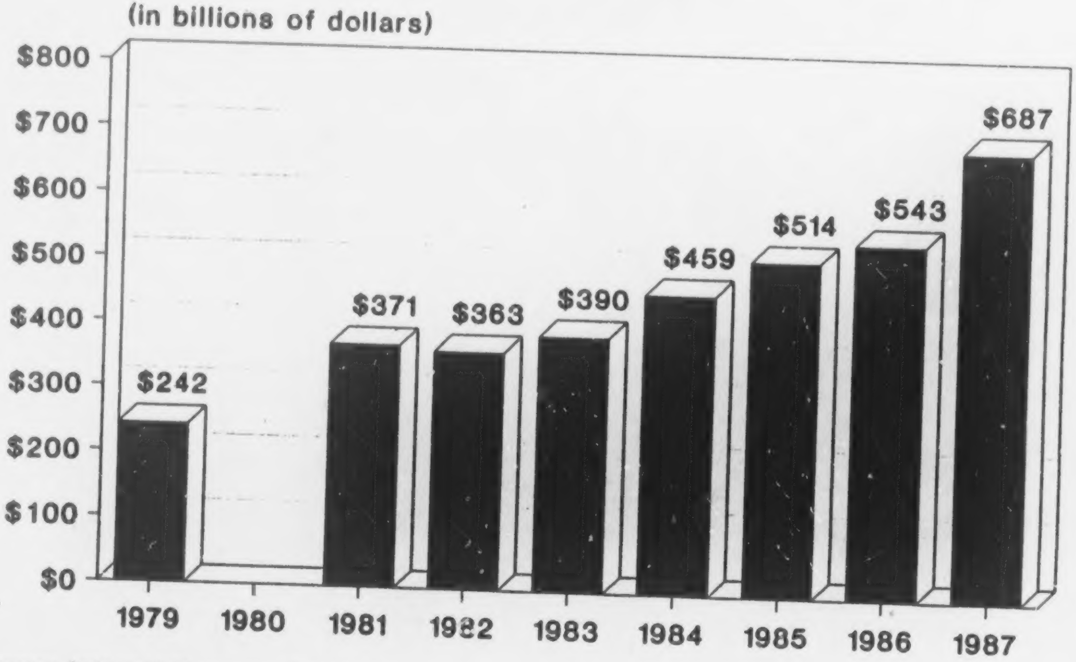
••1980 Not available

Foreign-Controlled U.S. Corporations
Total Assets



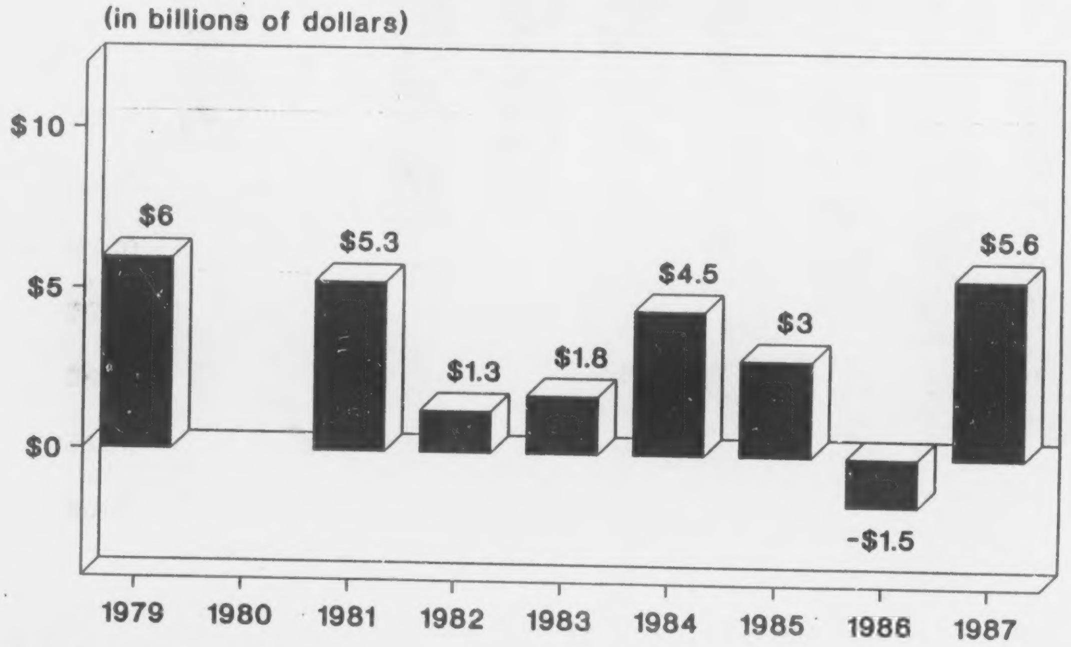
Source: Internal Revenue Service
••1980 Not available

Foreign-Controlled U.S. Corporations Total Receipts



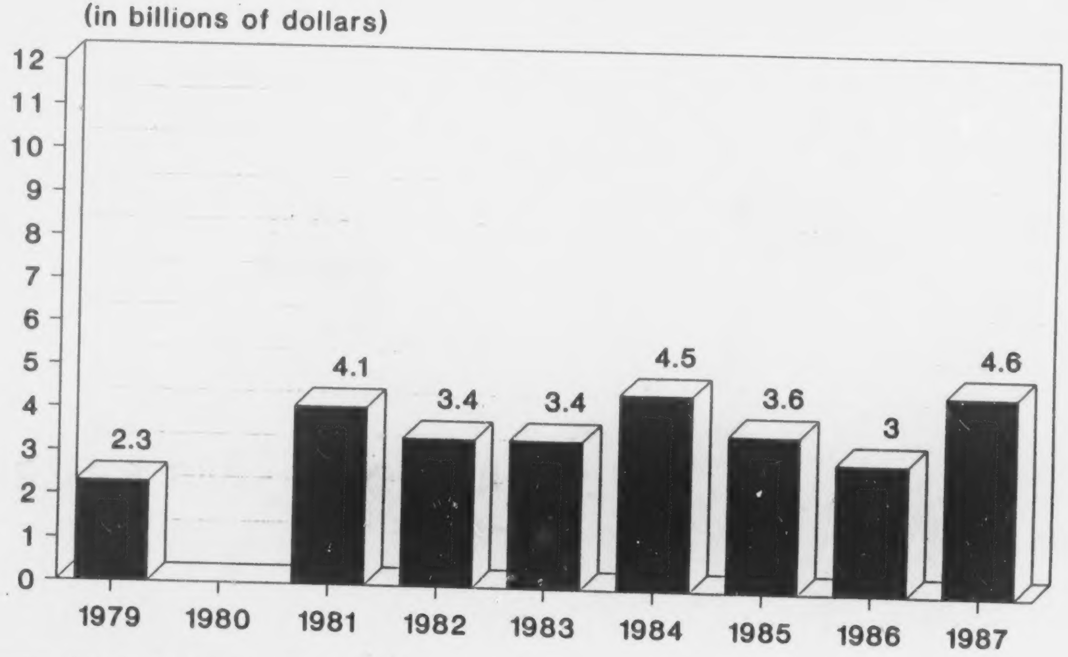
Source: Internal Revenue Service
**1980 Not available

Foreign-Controlled U.S. Corporations
Net Income, 1979-1987



Source: Internal Revenue Service
••1980 Not available

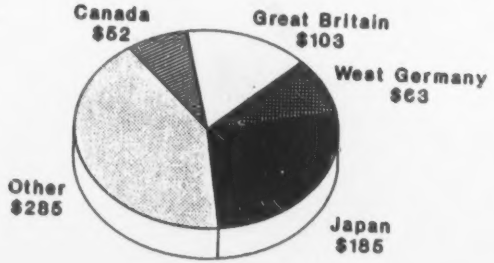
Foreign-Controlled U.S. Corporations U.S. Income Tax Paid

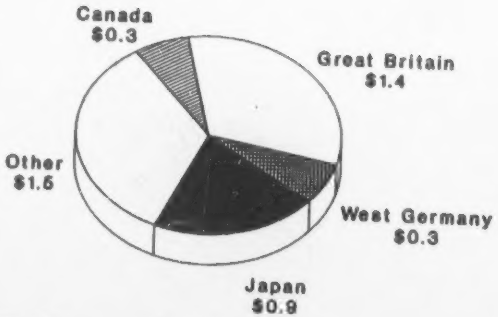


Source: Internal Revenue Service
••1980 Not available

Foreign-Controlled U.S. Corporations
(in billions of dollars)

1987 Receipts by Country



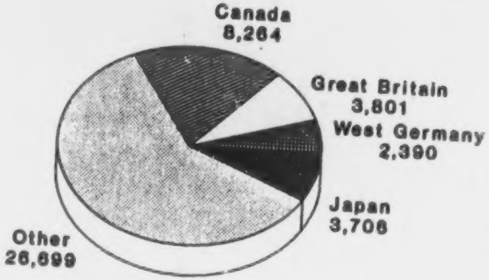


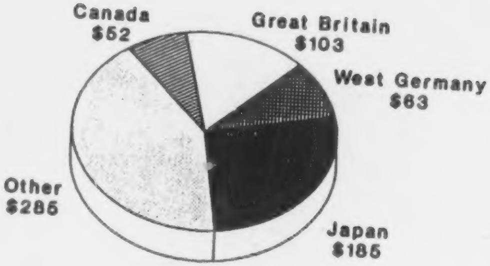
1987 Tax Paid by Country

Source: Internal Revenue Service

Foreign-Controlled U.S. Corporations

1987 Returns by Country





1987 Receipts by Country
(in billions of dollars)

Source: Internal Revenue Service

Chairman PICKLE. While this or other data may indicate that there is a problem, it does not tell the whole story. Harder questions need to be asked—and have been asked by this subcommittee.

The Oversight Subcommittee's objective in conducting the investigation was to go behind the IRS numbers and learn exactly which foreign subsidiaries have not met their tax responsibilities, how the game is played, and what if anything, the Congress can and should do.

The subcommittee staff obviously could not investigate the tax records, corporate filings, and case histories of the over 44,000 foreign-controlled subsidiaries in the United States. Instead, the subcommittee focused its investigation on 36 foreign-controlled distributors of automobiles, electronics equipment, and motorcycles and reviewed portions of over 200 tax returns filed over the past decade. In 1986, the companies accounted for more than $35 billion in retail sales made in the United States. Also, IRS reported to the subcommittee that a significant number of these companies have improperly reduced their U.S. tax liabilities through various transfer pricing schemes and other methods.

Under our tax laws, the IRS can prevent improper shifting of income by multinational corporations using section 482 of the Internal Revenue Code. This provision authorizes the IRS to allocate income, deductions, or credits among the related corporations when such allocation is necessary to prevent tax evasion or to clearly reflect the income of each. IRS has fallen short in effectively using its authority and protecting Federal revenues.

To summarize, some of the companies investigated have been operating in the United States for years and have never sent a check to Uncle Sam for one thin dime in corporate income taxes. They have failed to pay taxes despite the fact they have profited from selling billions of dollars of cars, motorcycles, stereos, televisions, VCR's, microwaves, and other products to the American consumer. Many of the companies that initially paid U.S. corporate income taxes subsequently incurred substantial losses which allowed them to both reduce their current year's taxes and recoup taxes previously paid. Questions continue to surface about whether certain companies, year after year, manipulate transfer prices in a deliberate effort to avoid paying taxes in the United States.

Many foreign multinational corporations are setting the transfer prices for their U.S. subsidiaries too high. By charging unrealistic, or nonarm's-length prices for goods and services, a multinational can transfer taxable profits from one country to another. For example, an artificially high transfer price for goods or services purchased from a foreign parent can reduce the U.S. subsidiary's profits, and thus, the taxes paid to the United States.

In addition, many foreign-controlled subsidiaries are claiming excessive insurance, interest, and freight costs, and expenses for promotional activities which are not correctly reflected in the transfer price. This appears to be a common practice and the method by which many of the companies the subcommittee reviewed reduced their U.S. taxes to little or nothing.

Let me describe one actual case that the subcommittee investigated which illustrates the transfer pricing issue. There is a foreign-owned company which has been operating in the United

States for decades, selling hundreds of millions of dollars worth of goods in the United States each year. The subcommittee looked at this corporation's Federal income tax returns for the past 10 years. The returns showed that over this period the company sold more than $3.5 billion in goods in the United States, had gross profits of almost $600 million, and paid only $500 in Federal income taxes.

Now, I ask: How can a company owned by a profitable foreign multinational, which has been very successful in marketing its products in this country, continue year after year to report losses and stay in business?

The subcommittee also learned of cases where foreign-owned corporations improperly shifted income from the United States through schemes set up to avoid Customs import duties. Some companies have been caught by Customs illegally reducing their duty payments through fraudulent shipping and insurance charges—and kickbacks—and the movement of goods in and out of the U.S. free trade zones with no meaningful paper trail. Again, I ask: Is the Federal Government getting whip-sawed and is anyone in the Federal Government in control? Further, do the different Federal agencies talk to each other and or let the others know the results of their investigations?

At this point, I want to emphasize that there are foreign-owned companies operating in the United States which comply with U.S. laws and pay substantial Federal corporate income taxes. The subcommittee found that several of the foreign-owned companies investigated did,, in fact, pay a significant level of U.S. tax, year-after-year, and that the IRS has examined their transfer pricing structure and found no problems.

Also, questions have been raised about whether U.S.-owned corporations are complying with the tax laws generally, and section 482 standards specifically. While not the focus of the subcommittee's investigation, the IRS Commissioner may be prepared to address such questions and the committee may want to look into these matters at a later date.

Finally, I do not believe that the IRS is equipped or able to effectively protect this country's tax system against section 482 transfer pricing abuse. The misallocation of profits among foreign multinationals and their subsidiaries will continue to present monumental problems unless the IRS has an effective international enforcement program.

We will hear today from IRS field agents who will paint a pretty dismal picture of what they call life in the trenches. Among other things, the IRS has only 40 economists on staff nationwide to work on all tax issues before the IRS, while the largest accounting firms have as many or more economists available to work on behalf of each of their corporate clients. Further, it seems that the game is to hire the experts yourself so that IRS can't; delay, delay, delay, and then don't extend the statute of limitations.

In some cases, the IRS is still auditing returns that were filed more than 10 years ago. The complexity of the issues, the attrition of experienced personnel, the lack of IRS resources, and the failure of these corporations to cooperate with information requests delayed the examination of these returns. Further, the subcommittee forced the IRS to look in their own backyard and determine the agency's success rate in sustaining their position in appeals, litigation and competent authority.

A detailed analysis is attached to my statement. I will put that in the record at this point.

[The information follows:]

a. Appeals Sustention Rates:

Fiscal Year:	1989	1988	1987
Proposed Adjustment	$1,224,686,318	$1,991,404,999	$563,716,721
Adjustment Sustained By Appeals	$506,537,594	$542,251,631	$133,669,236
Percentage Sustained	41%	27%	24%

Notes

1) As of March 31, 1990, there were 242 work units (cases) in Appeals with section 482 issues, and the total proposed adjustment for these issues was over $8.6 billion.

2) The above amounts come from an analysis of data recorded by Appeals officers. The collection of this data was not intended to be a source of information for sustention rate analysis. This data should not be quoted as exact amounts. However, it represents the best available information for the data you requested.

3) The "Proposed Adjustment" represents the amount of section 482 adjustments proposed by Examination on work units (cases) closed by Appeals during the fiscal year.

b. Competent Authority Sustention Rates:

Fiscal Year	1989	1990 (thru 4/30)	Total
Recommended	$ 68,580,235	$ 69,979,179	$ 138,559,414
Sustained	24,443,639	57,587,883	82,031,522
Percentage	35.6 %	82.3 %	59.2 %

Statistics relating to the sustention of section 482 adjustments by Competent Authority are only available from October 1988 to date. A sufficiently accurate system to gather the data reflected above was not on-line until the beginning of fiscal year 1989. In order to secure similar data for years prior to FY 1989, it would be necessary to examine in-depth each closed case file which would be an extremely labor intensive process. Given the relatively minor amount of section 482 adjustments which go to Competent Authority versus those going to Appeals, we suggest that such an effort is not appropriate.

Source: Internal Revenue Service, June 22, 1990

Chairman **Pickle**. This data seems to mean that either the IRS is not doing as good job at the front end, or the process operates to the detriment of the Federal Treasury. I am hopeful the IRS Commissioner will have suggestions for improvements to its international enforcement program. I ask: Is the IRS outgunned?

In the final analysis, information from these companies need to be made more timely and readily available to the Federal Government. Recent congressional efforts to strengthen the ability of the IRS to obtain critical information from foreign-controlled entities will undoubtedly help. Also, the IRS, U.S. Customs Service, the Department of Commerce and other Federal agencies need to better coordinate their efforts to enforce U.S. laws. The facts presented at this hearing should focus attention on these problems and generate additional ideas for improvements in the area. The facts presented at this hearing should serve as a catalyst for debate and serve as a foundation for needed reforms.

If there is no objection, the subcommittee hearing will proceed in the following manner. The subcommittee members will give their opening statements; the Joint Committee on Taxation staff will provide a brief description of present law regarding transfer pricing issues and the IRS process; and, the Oversight Subcommittee staff will provide a statement presenting the facts and results of the subcommittee's bipartisan staff investigation.

After these statements, the subcommittee will go into closed executive session to receive testimony from IRS field agents responsible for handling actual tax cases involving section 482 issues. Specific tax return and taxpayer information is protected from public disclosure by section 6103 of the Internal Revenue Code. Therefore, the subcommittee must receive the information in close session.

We will also be receiving testimony from Customs agents regarding related duty-avoidance schemes which involved sensitive business information protected by the Trade Secrets Act. I will ask that everyone promptly leave the room after completion of the Oversight staff statement.

At 1 p.m., hopefully, the public portion of the hearing will resume to receive the statement of the IRS Commissioner and statements by IRS field agents. Questioning of the witnesses will follow. We will also hear from the Customs Service this afternoon.

On Thursday, the second of hearings, the subcommittee will receive testimony from Members of Congress, the Assistant Secretary for Tax Policy for the Department of the Treasury, representatives of the Commerce Department, and a panel of economic and tax experts.

Finally, I have received several requests to present testimony in connection with these hearings. As outlined in the subcommittee's press release announcing the hearings, I urged interested parties to provide the subcommittee with written statements for the record. Depending on the number of statements submitted and the subcommittee's schedule later this month, we will make a decision on whether an additional hearing day is in order, and it looks like it may be. Any taxpayer has a right to present the facts in their case for the public record.

That completes my statement. I know it is a rather lengthy one, but I wanted to lay out the facts in advance. I will recognize Mr. Schulze for any opening statement he might make.

[Attachments to Chairman Pickle's statement follow:]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

JUL 6 1990

RECEIVED
JUL 9 1990
Ways and Means
Subcommittee on Oversight

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Ways and Means Committee
Washington, DC 20515

Dear Chairman:

In response to your request for certain Statistics Of Income (SOI) data in connection with the Subcommittee's hearing on IRC section 482 and related issues, I have enclosed the following information:

(1) SOI data on the number of returns, total receipts, and total U.S. income tax after credits of foreign-controlled U.S. corporations by selected countries for the years 1979 through 1987.

(2) SOI data relating to the number of returns, total receipts, adjusted taxable income, taxes due, and related ratios for foreign-controlled and domestic-controlled U.S. corporations by selected business activity codes for 1987.

(3) SOI data for foreign-controlled U.S. corporations by major entries on corporate tax returns such as receipts, deductions, and net income (less deficit).

(4) SOI data for selected items for both foreign-controlled and domestic-controlled U.S. corporations.

At the request of your staff, we previously faxed to your office our earliest version of this data. Please note that there are some minor changes in the final figures for item (2) listed above.

We are pleased to be of service in your continuing review of taxpayer noncompliance and the tax gap. Do not hesitate to contact me if you have any questions.

Sincerely,

for/ Michael J. Murphy
Fred T. Goldberg
Commissioner

Attachment

Domestic Corporations Controlled by a Foreign Person: Number of Returns, Total Receipts and Total U.S. Income Tax After Credits, by Selected Countries, 1979-1987

[All figures are estimates based on samples--money amounts are in millions of dollars]

YEAR	ALL COUNTRIES	CANADA	JAPAN	UNITED KINGDOM	WEST GERMANY
			NUMBER OF RETURNS		
1979	20,288	5,515	1,458	1,441	1,432
1980	N/A	N/A	N/A	N/A	N/A
1981	27,626	7,065	2,177	2,026	1,615
1982	35,833	6,924	1,624	2,096	2,665
1983	33,622	6,860	2,292	2,127	2,217
1984	37,401	6,389	2,399	2,680	1,842
1985	36,677	6,151	2,560	2,841	2,214
1986	36,778	6,708	2,688	2,588	2,662
1987	44,862	8,264	3,708	3,801	2,390
TOTAL	273,087	53,876	18,906	19,600	17,037
			TOTAL RECEIPTS		
1979	242,358	22,473	63,598	26,122	20,586
1980	N/A	N/A	N/A	N/A	N/A
1981	371,344	25,538	86,026	43,957	38,800
1982	363,223	21,709	79,987	57,523	27,847
1983	389,909	29,429	87,543	65,743	32,087
1984	459,162	31,634	112,607	76,884	36,442
1985	513,778	40,458	133,490	83,340	42,945
1986	542,695	40,354	126,092	83,823	53,362
1987	686,786	51,549	184,861	102,993	62,779
TOTAL	3,569,255	263,144	874,204	540,385	314,848
			TOTAL U.S. INCOME TAX AFTER CREDITS		
1979	2,326	198	303	308	90
1980	N/A	N/A	N/A	N/A	N/A
1981	4,124	120	591	318	214
1982	3,454	94	587	1,318	282
1983	3,419	151	672	1,067	329
1984	4,488	209	1,144	1,148	423
1985	3,576	201	1,117	904	449
1986	3,043	252	947	588	200
1987	4,561	347	951	1,412	351
TOTAL	28,991	1,572	6,312	7,063	2,338

N/A - Not available. NOTE: Totals are for 1979-1987, excluding 1980.

Source: Statistics of Income Division, Internal Revenue Service
June 1990

1987 Foreign-Owned U.S. Corporations

[All figures are estimates based on sample data]
All dollar amounts are in Millions

Activity	Returns	Receipts	Adjusted Taxable Income	Tax after Credits	Total Assets	Ratio #1	Ratio #2	Ratio #3	Ratio #4	Ratio #5
3710	87	6,325	48	10	6,743	0.16%	0.76%	0.72%	98.34%	14.54%
5010	348	68,328	1,467	586	27,802	0.86	2.15	5.28	109.42	10.88
5515	79	3,070	46	12	1,104	0.38	1.50	4.17	96.54	13.50
3630	3	3,452	71	14	1,989	0.41	2.05	3.56	106.42	25.15
3665	62	8,542	373	72	9,691	0.84	4.37	3.85	99.23	38.34
3670	125	8,898	203	63	5,237	0.71	2.28	3.87	89.29	21.14
5040	309	6,684	110	33	3,326	0.50	1.65	3.31	99.72	23.69
5060	1,188	24,925	478	135	13,903	0.54	1.92	3.44	100.69	19.46
Other	42,660	556,560	15,907	3,636	889,600	0.65	2.86	1.79	91.00	23.33
Total	44,862	686,706	18,704	4,561	959,394	0.66	2.72	1.95	92.05	22.00

Notes Adjusted Taxable Income is taxable income before the reduction by the net operating loss carry-over/back, but after allowing special deductions.

Operating Costs are total deductions less interest paid and cost of goods sold and/or operations.

Ratios are:

Ratio # 1: Tax after credits divided by Receipts;
Ratio # 2: Adjusted Taxable Income divided by Receipts;
Ratio # 3: Adjusted Taxable Income divided by Assets;
Ratio # 4: Gross Income (Sales less Cost of Goods Sold and/or Operations) divided by Operating Costs;
Ratio # 5: Gross Income divided by Receipts

1987 U. S. Owned Corporations

Activity	Returns	Receipts	Adjusted Taxable Income	Tax after Credits	Total Assets	Ratio #1	Ratio #2	Ratio #3	Ratio #4	Ratio #5
3710	1,477	351,073	6,976	1,961	371,756	0.56%	1.99%	1.88%	96.14%	18.65%
5010	15,285	41,196	920	295	16,325	0.72	2.23	5.64	102.62	21.61
5515	25,522	181,739	1,452	371	47,785	0.20	0.80	3.04	92.71	12.53
3630	157	10,714	623	217	9,744	2.03	5.81	6.39	113.44	28.21
3665	1,889	22,924	1,170	250	18,139	1.09	5.10	6.45	98.45	34.50
3670	8,386	83,119	4,468	973	71,936	1.17	5.38	6.21	97.65	32.24
5040	4,906	8,802	288	82	4,179	0.94	3.28	6.90	97.97	25.34
5060	13,879	43,065	1,239	389	19,186	0.90	2.88	6.46	103.96	24.35
Other	2,350,140	7,065,321	315,291	75,319	12,371,084	1.07	4.55	2.56	91.02	31.49
Total	2,421,643	7,672,966	332,427	79,858	12,834,833	1.04	4.33	2.59	91.30	30.38

Notes Includes only corporations filing on 1120, 1120A, 1120L or 1120PC (industry code 6359).

Adjusted Taxable Income is taxable income before the reduction by the net operating loss carry-over/back, but after allowing special deductions.

Operating Costs are total deductions less interest paid and cost of goods sold and/or operations.

Ratios are:

Ratio # 1: Tax after credits divided by Receipts;
Ratio # 2: Adjusted Taxable Income divided by Receipts;
Ratio # 3: Adjusted Taxable Income divided by Assets;
Ratio # 4: Gross Income (Sales less Cost of Goods Sold) divided by Operating Costs;
Ratio # 5: Gross Income divided by Receipts

ANALYSIS OF SOI DATA FOR FOREIGN CONTROLLED U. S. CORPORATIONS

(Dollar Amounts in Millions)

ITEM	1978	1979	1981	1982	1983	1984	1985	1986	1987
Number of Returns	14,351	20,288	27,626	35,833	33,622	37,401	36,677	36,778	44,862
Total Assets	$ 152,686	$ 205,021	$ 383,702	$ 449,483	$ 530,334	$ 552,598	$ 655,696	$ 840,893	$ 959,394
Total Receipts	181,795	242,358	371,344	363,223	389,909	459,162	513,778	542,695	686,786
Business Receipts	174,739	231,528	342,958	330,092	359,793	423,602	473,893	497,304	632,731
Interest Received (1)	2,922	5,355	18,725	20,047	17,590	20,220	22,717	24,464	28,232
Total Deductions	177,826	236,414	365,938	361,897	387,981	454,642	510,955	544,237	681,349
Cost of Sales/Operations	139,929	185,009	265,998	253,157	271,373	320,857	357,520	370,779	481,645
Interest Paid	5,267	8,753	23,615	26,133	22,255	25,586	27,645	28,166	35,571
Net Income (Less Deficit)	3,963	5,978	5,270	1,308	1,849	4,528	2,978	(1,519)	5,608
Income Tax Before Credits	2,306	3,526	5,731	4,905	4,849	6,050	5,152	4,070	5,676
Foreign Tax Credit	320	478	794	769	671	788	725	484	660
Income Tax After Credits	1,616	(n/a)	4,125	3,455	3,419	4,488	3,576	3,043	4,561
Distributions to Sareholders (except in Company's Stock)	1,021	1,745	2,622	0	4,327	3,322	3,529	5,568	11,831

Notes:

Interest Received does not include Interest on government obligations, state or local.
1979 Income tax after credits cannot be computed due to programming errors.
Data for Tax Year 1980 is not available.

DOMESTIC CORPORATIONS CONTROLLED BY A FOREIGN PERSON COMPARED TO OTHER DOMESTIC CORPORATIONS: SELECTED ITEMS AND KEY RATIOS, 1979-1987

[All figures are estimates based on samples--money amounts are in millions of dollars]

ITEM OR RATIO	1979	1980	1981	1982	1983	1984	1985	1986	1987
Total assets:									
Foreign-controlled domestic corporations	205,021	N/A	383,702	449,483	530,335	552,580	655,696	840,893	959,394
Other domestic corps. 1/	6,344,543	N/A	7,698,510	8,374,630	9,096,976	9,848,897	11,233,456	12,120,430	12,834,833
Total receipts:									
Foreign-controlled domestic corporations	242,358	N/A	371,344	363,223	389,909	459,162	513,778	542,695	686,786
Other domestic corps. 1/	5,040,420	N/A	6,289,063	6,264,054	6,309,227	6,845,775	7,280,540	7,431,692	7,672,966
Net income (less deficit):									
Foreign-controlled domestic corporations	5,978	N/A	5,270	1,308	1,849	4,528	2,978	(1,519)	5,608
Other domestic corps. 1/	247,955	N/A	171,105	110,649	143,900	183,522	191,456	201,988	238,963

N/A - Not available.
1/ Includes the following forms: 1120, 1120A, 1120L, and 1120PC (industry code 6359). Excludes the following forms: 1120S, 1120F, 1120-IC-DISC, 1120-FSC, 1120-RIC, 1120-REIT, and 1120PC (industry code 6356).
Source: Statistics of Income, Internal Revenue Service
June 1990

LEGEND FOR TERMS USING THE 1989 FORM 1120

Receipts = Line 11 + Line 2 + Tax Exempt Interest from Sch. M-1

U.S. Income Tax After Credits = Line 31
note: not adjusted for net operating loss (NOL) carryback or audit adjustments

Adjusted Taxable Income = Line 28 less Line 29(b) only
notes: includes only positive taxable income amounts; not reduced by NOL carryforwards on Line 29(a)

LEGEND FOR 1120s REFERRED TO ON CHART 4

1120A	Short form for corporations
1120L	Filed by life insurance companies
1120PC	Filed by property and casualty insurance companies
1120S	Filed by Subchapter S corporations
1120F	Filed by foreign corporations (i.e. not incorporated in the U.S.)
1120-IC-DISC	Filed by interest charge domestic international sales corporations
1120-FSC	Filed by foreign sales corporations
1120-RIC	Filed by regulated investment companies
1120-REIT	Filed by real estate investment trusts

LEGEND FOR ACTIVITY CODES ON CHART 2

Please see the next page for these activity codes

Codes for Principal Business Activity

These codes for the Principal Business Activity are designed to classify enterprises by the type of activity in which they are engaged to facilitate the administration of the Internal Revenue Code. Though similar in format and structure to the Standard Industrial Classification Codes (SIC), they should not be used as SIC codes.

Using the list below, enter on page 3, under H(1), Form 1120, or on page 2, under G(1), Form 1120-A, the code number for the specific industry group from which the largest percentage of "total receipts" is derived. "Total receipts" means gross receipts (line 1a, page 1) plus all other income (lines 4 through 10, page 1).

On page 3, under H(2) and H(3), Form 1120, or on page 2, under G(2) and G(3), Form 1120-A, state the principal business activity and principal product or service that account for the largest percentage of total receipts. For example, if the principal business activity is "Grain mill products," the principal product or service may be "Cereal preparations."

If, as its principal business activity, the corporation: (1) purchases raw materials, (2) subcontracts out for labor to make a finished product from the raw materials, and (3) retains title to the goods, the corporation is considered to be a manufacturer and must enter one of the codes (2010-3998) under "Manufacturing."

Agriculture, Forestry, and Fishing

Code	
0400	Agricultural production
0600	Agricultural services (except veterinarians), forestry, fishing, hunting, and trapping

Mining

Metal mining

1010	Iron ores
1070	Copper, lead and zinc, gold and silver ores
1098	Other metal mining
1150	Coal mining

Oil and gas extraction

1330	Crude petroleum, natural gas, and natural gas liquids
1380	Oil and gas field services

Nonmetallic minerals, except fuels

1430	Dimension, crushed and broken stone; sand and gravel
1498	Other nonmetallic minerals, except fuels

Construction

General building contractors and operative builders

1510	General building contractors
1531	Operative builders
1600	**Heavy construction contractors**

Special trade contractors

1711	Plumbing, heating, and air conditioning
1731	Electrical work
1798	Other special trade contractors

Manufacturing

Food and kindred products

2010	Meat products
2020	Dairy products
2030	Preserved fruits and vegetables
2040	Grain mill products
2050	Bakery products
2060	Sugar and confectionary products
2081	Malt liquors and malt
2088	Alcoholic beverages, except malt liquors and malt
2089	Bottled soft drinks, and flavorings
2096	Other food and kindred products
2100	**Tobacco manufacturers**

Textile mill products

2228	Weaving mills and textile finishing
2250	Knitting mills
2298	Other textile mill products

Apparel and other textile products

2315	Men's and boys' clothing
2345	Women's and children's clothing
2388	Other apparel and accessories
2390	Miscellaneous fabricated textile products

Lumber and wood products

2415	Logging, sawmills, and planing mills
2430	Millwork, plywood, and related products
2498	Other wood products, including wood buildings and mobile homes
2500	**Furniture and fixtures**

Code

Paper and allied products

2625	Pulp, paper, and board mills
2699	Other paper products

Printing and publishing

2710	Newspapers
2720	Periodicals
2735	Books, greeting cards, and miscellaneous publishing
2799	Commercial and other printing, and printing trade services

Chemicals and allied products

2815	Industrial chemicals, plastics materials, and synthetics
2830	Drugs
2840	Soap, cleaners, and toilet goods
2850	Paints and allied products
2898	Agricultural and other chemical products

Petroleum refining and related industries (including those integrated with extraction)

2910	Petroleum refining (including integrated)
2998	Other petroleum and coal products

Rubber and misc. plastics products

3050	Rubber products, plastics footwear, hose and belting
3070	Misc. plastics products

Leather and leather products

3140	Footwear, except rubber
3198	Other leather and leather products

Stone, clay, and glass products

3225	Glass products
3240	Cement, hydraulic
3270	Concrete, gypsum, and plaster products
3298	Other nonmetallic mineral products

Primary metal industries

3370	Ferrous metal industries; misc. primary metal products
3380	Nonferrous metal industries

Fabricated metal products

3410	Metal cans and shipping containers
3428	Cutlery, hand tools, and hardware; screw machine products, bolts, and similar products
3430	Plumbing and heating, except electric and warm air
3440	Fabricated structural metal products
3460	Metal forgings and stampings
3470	Coating, engraving, and allied services
3480	Ordnance and accessories, except vehicles and guided missiles
3490	Misc. fabricated metal products

Machinery, except electrical

3520	Farm machinery
3530	Construction and related machinery
3540	Metalworking machinery
3550	Special industry machinery
3560	General industrial machinery
3570	Office, computing, and accounting machines
3598	Other machinery except electrical

Code

Electrical and electronic equipment

3630	Household appliances
3665	Radio, television, and communication equipment
3670	Electronic components and accessories
3698	Other electrical equipment
3710	**Motor vehicles and equipment**

Transportation equipment, except motor vehicles

3725	Aircraft, guided missiles and parts
3730	Ship and boat building and repairing
3798	Other transportation equipment, except motor vehicles

Instruments and related products

3815	Scientific instruments and measuring devices; watches and clocks
3845	Optical, medical, and ophthalmic goods
3860	Photographic equipment and supplies
3998	**Other manufacturing products**

Transportation and Public Utilities

Transportation

4000	Railroad transportation
4100	Local and interurban passenger transit
4200	Trucking and warehousing
4400	Water transportation
4500	Transportation by air
4600	Pipe lines, except natural gas
4700	Miscellaneous transportation services

Communication

4825	Telephone, telegraph, and other communication services
4830	Radio and television broadcasting

Electric, gas, and sanitary services

4910	Electric services
4920	Gas production and distribution
4930	Combination utility services
4990	Water supply and other sanitary services

Wholesale Trade

Durable

5008	Machinery, equipment, and supplies
5010	Motor vehicles and automotive equipment
5020	Furniture and home furnishings
5030	Lumber and construction materials
5040	Sporting, recreational, photographic, and hobby goods, toys and supplies
5050	Metals and minerals, except petroleum and scrap
5060	Electrical goods
5070	Hardware, plumbing and heating equipment and supplies
5098	Other durable goods

Nondurable

5110	Paper and paper products
5129	Drugs, drug proprietaries, and druggists' sundries
5130	Apparel, piece goods, and notions
5140	Groceries and related products
5150	Farm-product raw materials
5160	Chemicals and allied products
5170	Petroleum and petroleum products
5180	Alcoholic beverages
5190	Misc. nondurable goods

Retail Trade

Building materials, garden supplies, and mobile home dealers

5220	Building materials dealers
5251	Hardware stores
5265	Garden supplies and mobile home dealers
5300	**General merchandise stores**

Food stores

5410	Grocery stores
5490	Other food stores

Automotive dealers and service stations

5511	Motor vehicle dealers
5541	Gasoline service stations
5598	Other automotive dealers
5600	**Apparel and accessory stores**
5700	**Furniture and home furnishings stores**

Code

5800	**Eating and drinking places**

Misc. retail stores

5912	Drug stores and proprietary stores
5921	Liquor stores
5995	Other retail stores

Finance, Insurance, and Real Estate

Banking

6030	Mutual savings banks
6060	Bank holding companies
6090	Banks, except mutual savings banks and bank holding companies

Credit agencies other than banks

6120	Savings and loan associations
6140	Personal credit institutions
6150	Business credit institutions
6199	Other credit agencies

Security, commodity brokers and services

6210	Security brokers, dealers, and flotation companies
6299	Commodity contracts brokers and dealers; security and commodity exchanges; and allied services

Insurance

6355	Life insurance
6356	Mutual insurance, except life or marine and certain fire or flood insurance companies
6359	Other insurance companies
6411	Insurance agents, brokers, and service

Real estate

6511	Real estate operators and lessors of buildings
6516	Lessors of mining, oil, and similar property
6518	Lessors of railroad property and other real property
6530	Condominium management and cooperative housing associations
6550	Subdividers and developers
6599	Other real estate

Holding and other investment companies, except bank holding companies

6744	Small business investment companies
6749	Other holding and investment companies except bank holding companies

Services

7000	**Hotels and other lodging places**
7200	**Personal services**

Business services

7310	Advertising
7389	Business services, except advertising

Auto repair; misc. repair services

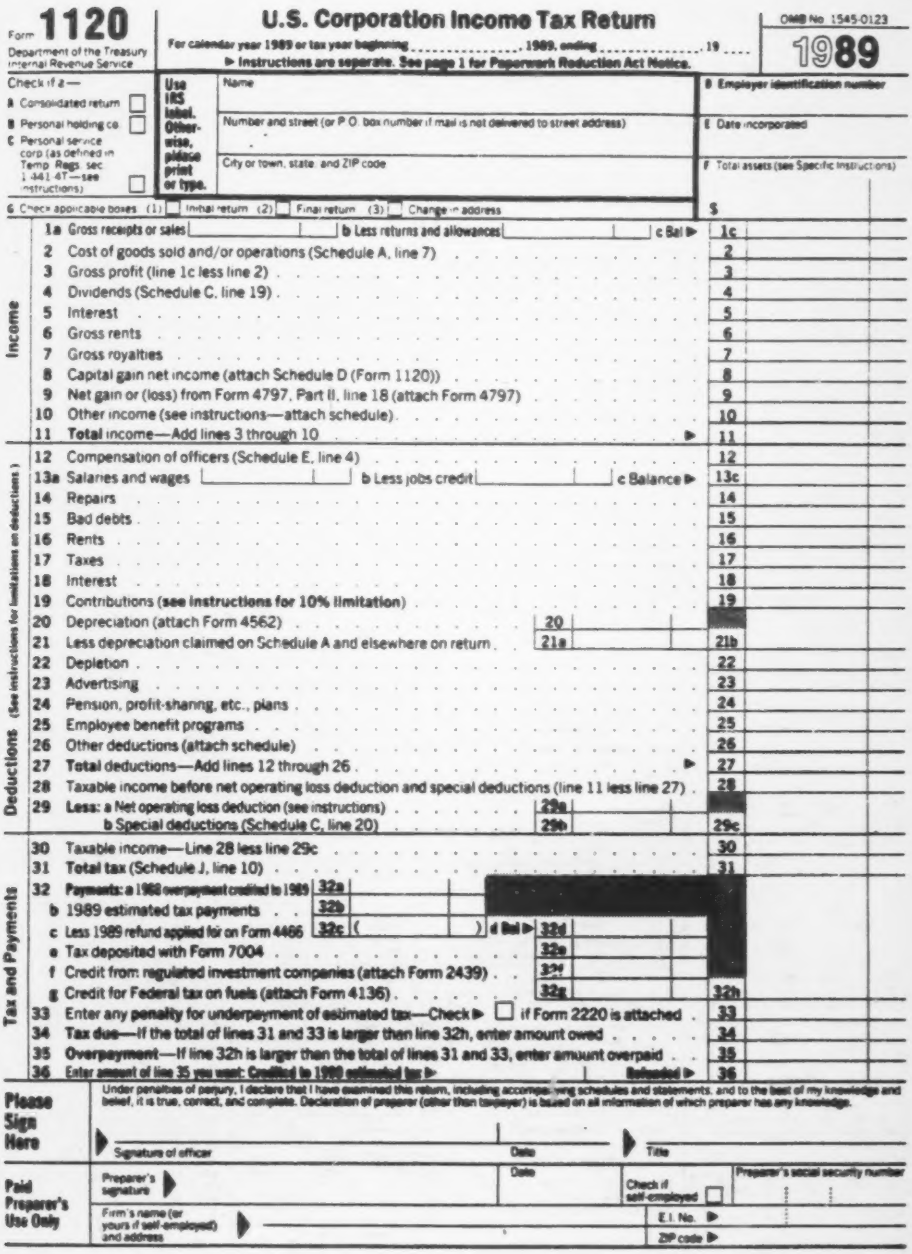
7500	Auto repair and services
7600	Misc. repair services

Amusement and recreation services

7812	Motion picture production, distribution, and services
7830	Motion picture theaters
7900	Amusement and recreation services, except motion pictures

Other services

8015	Offices of physicians, including osteopathic physicians
8021	Offices of dentists
8040	Offices of other health practitioners
8050	Nursing and personal care facilities
8060	Hospitals
8071	Medical laboratories
8099	Other medical services
8111	Legal services
8200	Educational services
8300	Social services
8600	Membership organizations
8911	Architectural and engineering services
8930	Accounting, auditing, and bookkeeping
8980	Miscellaneous services (including veterinarians)



Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1989 or tax year beginning ...., 1989, ending ...., 19 ....
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123
1989

Check if a—
A Consolidated return ☐
B Personal holding co. ☐
C Personal service corp. (as defined in Temp. Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, please print or type.
Name
Number and street (or P.O. box number if mail is not delivered to street address)
City or town, state, and ZIP code

D Employer identification number
E Date incorporated
F Total assets (see Specific Instructions)
$

G Check applicable boxes (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address

Income	1a	Gross receipts or sales ______ b Less returns and allowances ______ c Bal ▶	1c
	2	Cost of goods sold and/or operations (Schedule A, line 7)	2
	3	Gross profit (line 1c less line 2)	3
	4	Dividends (Schedule C, line 19)	4
	5	Interest	5
	6	Gross rents	6
	7	Gross royalties	7
	8	Capital gain net income (attach Schedule D (Form 1120))	8
	9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)	9
	10	Other income (see instructions—attach schedule)	10
	11	**Total** income—Add lines 3 through 10 ▶	11
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)	12
	13a	Salaries and wages ______ b Less jobs credit ______ c Balance ▶	13c
	14	Repairs	14
	15	Bad debts	15
	16	Rents	16
	17	Taxes	17
	18	Interest	18
	19	Contributions (**see instructions for 10% limitation**)	19
	20	Depreciation (attach Form 4562) 20 ______	
	21	Less depreciation claimed on Schedule A and elsewhere on return 21a ______	21b
	22	Depletion	22
	23	Advertising	23
	24	Pension, profit-sharing, etc., plans	24
	25	Employee benefit programs	25
	26	Other deductions (attach schedule)	26
	27	**Total** deductions—Add lines 12 through 26 ▶	27
	28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	28
	29	**Less:** a Net operating loss deduction (see instructions) 29a ______	
		b Special deductions (Schedule C, line 20) 29b ______	29c
Tax and Payments	30	Taxable income—Line 28 less line 29c	30
	31	**Total tax** (Schedule J, line 10)	31
	32	**Payments:** a 1988 overpayment credited to 1989 32a ______	
		b 1989 estimated tax payments 32b ______	
		c Less 1989 refund applied for on Form 4466 32c (______) d Bal ▶ 32d ______	
		e Tax deposited with Form 7004 32e ______	
		f Credit from regulated investment companies (attach Form 2439) 32f ______	
		g Credit for Federal tax on fuels (attach Form 4136) 32g ______	32h
	33	Enter any **penalty for underpayment of estimated tax**—Check ▶ ☐ if Form 2220 is attached	33
	34	**Tax due**—If the total of lines 31 and 33 is larger than line 32h, enter amount owed	34
	35	**Overpayment**—If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35
	36	Enter amount of line 35 you want: **Credited to 1990 estimated tax ▶** ______ **Refunded ▶**	36

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ ______ Signature of officer | Date ▶ ______ Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number
Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Schedule A Cost of Goods Sold and/or Operations (See instructions for line 2, page 1.)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4a	Additional section 263A costs (see instructions—attach schedule)	4a	
b	Other costs (attach schedule)	4b	
5	Total—Add lines 1 through 4b	5	
6	Inventory at end of year	6	
7	Cost of goods sold and/or operations—Line 5 less line 6. Enter here and on line 2, page 1	7	

8a Check all methods used for valuing closing inventory:

(i) ☐ Cost (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4 (see instructions)

(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see instructions)

(iv) ☐ Other (Specify method used and attach explanation.) ▶ ....

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 8c ______

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

Schedule C Dividends and Special Deductions (See instructions.)

		(a) Dividends received	(b) %	(c) Special deductions: (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		41.176	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		47.059	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	Total—Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Forms 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities (see instructions)			
19	Total dividends—Add lines 1 through 17. Enter here and on line 4, page 1. ▶			
20	Total deductions—Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			

Schedule E Compensation of Officers (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a, plus lines 4 through 10, of page 1, Form 1120) are $500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned		(f) Amount of compensation
				(d) Common	(e) Preferred	
1			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	
3	Less: Compensation of officers claimed on Schedule A and elsewhere on return	( )
4	Compensation of officers deducted on line 12, page 1	

[illegible] Tax Computation

1 Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . . . ▶ ☐

2 If the box on line 1 is checked:

a Enter your share of the $50,000 and $25,000 taxable income bracket amounts (in that order): (i) $ (ii) $

b Enter your share of the additional 5% tax (not to exceed $11,750) ▶ $

3 Income tax (see instructions to figure the tax). Check this box if the corporation is a qualified personal service corporation (see instructions). ▶ ☐ 3

4a Foreign tax credit (attach Form 1118) 4a

b Possessions tax credit (attach Form 5735) 4b

c Orphan drug credit (attach Form 6765) 4c

d Credit for fuel produced from a nonconventional source (see instructions) 4d

e General business credit. Enter here and check which forms are attached: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 . . . . 4e

f Credit for prior year minimum tax (attach Form 8801) 4f

5 Total—Add lines 4a through 4f 5

6 Line 3 less line 5 6

7 Personal holding company tax (attach Schedule PH (Form 1120)) 7

8 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611 8

9a Alternative minimum tax (attach Form 4626) 9a

b Environmental tax (attach Form 4626) 9b

10 Total tax—Add lines 6 through 9b. Enter here and on line 31, page 1 10

Additional Information (See instruction F.)

Yes No

H Refer to the list in the instructions and state the principal:

(1) Business activity code no. ▶ ....

(2) Business activity ▶ ....

(3) Product or service ▶ ....

I (1) Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) . . ☐ ☐

If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.

(2) Did any individual, partnership, corporation, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (c) . . . . ☐ ☐

(a) Attach a schedule showing name, address, and identifying number.

(b) Enter percentage owned ▶ ....

(c) Was the owner of such voting stock a person other than a U.S. person? (See instructions.) Note: *If "Yes," the corporation may have to file Form 5472.* . . . . . ☐ ☐

If "Yes," enter owner's country ▶ ....

J Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) . . . . ☐ ☐

If "Yes," attach Form 5471 for each such corporation.

Yes No

K At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? . . . . ☐ ☐

(See instruction F and filing requirements for form TD F 90-22.1.)

If "Yes," enter name of foreign country ▶ ....

L Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation has any beneficial interest in it? . . . . ☐ ☐

If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926.

M During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) . . . . ☐ ☐

If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.

N During this tax year, did the corporation maintain any part of its accounting/tax records on a computerized system? . . . . . . ☐ ☐

O Check method of accounting:

(1) ☐ Cash

(2) ☐ Accrual

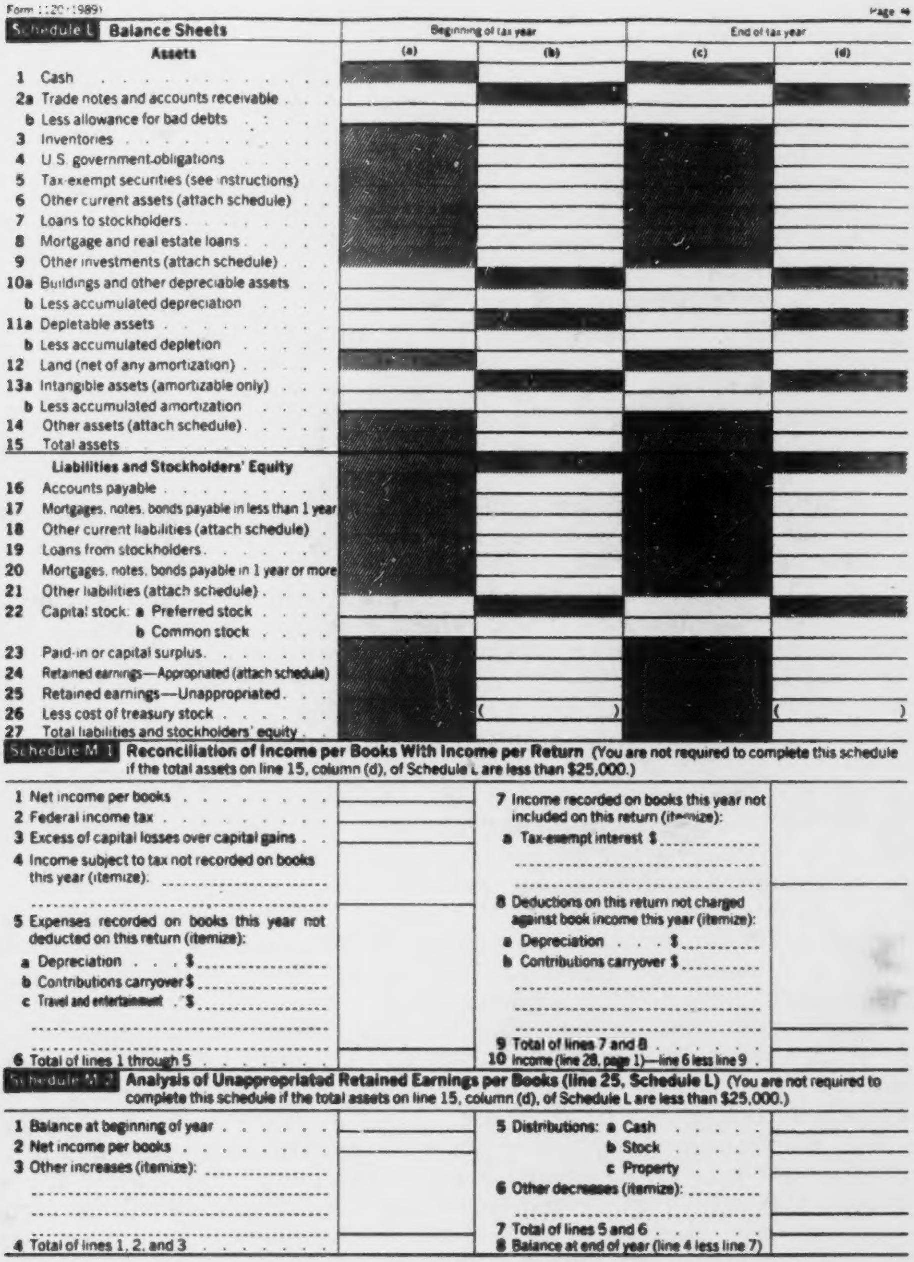
(3) ☐ Other (specify) ▶ ....

P Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ☐

If so, the corporation may have to file Form 8281.

Q Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $

R Enter the number of shareholders at the end of the tax year if there were 35 or fewer shareholders ▶



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Schedule L Balance Sheets

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash	▨		▨	
2a Trade notes and accounts receivable		▨		▨
b Less allowance for bad debts				
3 Inventories	▨		▨	
4 U.S. government obligations	▨		▨	
5 Tax-exempt securities (see instructions)	▨		▨	
6 Other current assets (attach schedule)	▨		▨	
7 Loans to stockholders	▨		▨	
8 Mortgage and real estate loans	▨		▨	
9 Other investments (attach schedule)	▨		▨	
10a Buildings and other depreciable assets		▨		▨
b Less accumulated depreciation				
11a Depletable assets		▨		▨
b Less accumulated depletion				
12 Land (net of any amortization)	▨		▨	
13a Intangible assets (amortizable only)		▨		▨
b Less accumulated amortization				
14 Other assets (attach schedule)	▨		▨	
15 Total assets	▨		▨	
Liabilities and Stockholders' Equity	▨	▨	▨	▨
16 Accounts payable	▨		▨	
17 Mortgages, notes, bonds payable in less than 1 year	▨		▨	
18 Other current liabilities (attach schedule)	▨		▨	
19 Loans from stockholders	▨		▨	
20 Mortgages, notes, bonds payable in 1 year or more	▨		▨	
21 Other liabilities (attach schedule)	▨		▨	
22 Capital stock: a Preferred stock		▨		▨
b Common stock				
23 Paid-in or capital surplus	▨		▨	
24 Retained earnings—Appropriated (attach schedule)	▨		▨	
25 Retained earnings—Unappropriated	▨		▨	
26 Less cost of treasury stock	▨	( )	▨	( )
27 Total liabilities and stockholders' equity	▨		▨	

Schedule M-1 Reconciliation of Income per Books With Income per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books		7 Income recorded on books this year not included on this return (itemize): a Tax-exempt interest $	
2 Federal income tax			
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize):		8 Deductions on this return not charged against book income this year (itemize): a Depreciation . . . $ b Contributions carryover $	
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation . . . $ b Contributions carryover $ c Travel and entertainment $		9 Total of lines 7 and 8	
6 Total of lines 1 through 5		10 Income (line 28, page 1)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 25, Schedule L) (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Balance at beginning of year		5 Distributions: a Cash	
2 Net income per books		b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
		7 Total of lines 5 and 6	
4 Total of lines 1, 2, and 3		8 Balance at end of year (line 4 less line 7)	

Mr. SCHULZE. Thank you, Mr. Chairman.

I join with you in opening our hearing on the tax payments of U.S. subsidiaries which are controlled by foreign owners. The United States is the best consumer market in the world. It is a market where businesses are engaged to compete for sales by constantly improving their products. We have not closed our markets to foreign participation. Foreign businesses are welcome to invest and to participate in our markets.

The theory behind this position is that competition is healthy for the economy and strengthens the overall system. Part of the theory is that the foreign-owned businesses also will pay their fair share of income tax on their U.S. earnings.

However, there have been eye opening reports in the press that foreign-owned subsidiaries are paying an abnormally low amount of U.S. income tax despite increasing gross receipts. The implication is that their low tax payments are not just part of the normal business cycle but part of a long-term pattern of tax avoidance.

If foreign-owned subsidiaries are avoiding U.S. income tax, it has several effects. First, it robs the U.S. Treasury of significant amounts of revenue. Before Congress acts to raise taxes on the average citizen in order to reduce the deficit, we should be sure that U.S. subsidiaries are paying their fair share of the current tax load.

Second, if foreign subsidiaries are paying little U.S. income tax, then our domestic companies face unfair competition in trying to pursue sales and market share in a given line of products.

Mr. Chairman, I have reviewed the available information and it raises serious questions about whether foreign-owned subsidiaries are using tax avoidance measures to eliminate their U.S. income tax liability. Over the next 2 days the subcommittee should be able to either corroborate or rebut this contention.

If it appears that manipulation of the transfer pricing rules is responsible for tax avoidance, then we should explore ways to improve the operation of section 482. An even broader question involves whether we should continue with the arm's-length standard in section 482 or whether we should explore new approaches such as a business transfer tax, or perhaps a unitary model.

Mr. Chairman, the United States has maintained an open door policy to foreign business participation. An open door to the most attractive consumer market in the world. How have foreign businesses responded to this opportunity?

Are they grateful or are they ingrates? My constituents have no tolerance for any foreign business which would exploit the openness of our society but refuse to contribute to the support that system by not paying a fair share in income taxes.

Mr. Chairman, these are serious issues. They have implications for our tax policy and even for our trade policy. We should move beyond the press reports and speculation by examining all the facts and deciding whether or not foreign-owned U.S. subsidiaries are paying a realistic amount of U.S. income tax on their U.S. earnings.

I look forward to learning from our witnesses today. And I join you in welcoming them to our hearing.

Chairman PICKLE. Thank you, Mr. Schulze.

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

I think you summarized my thoughts on page 3 of your statement when you ask the following question: How could a company owned by a profitable foreign multinational which has been very successful in marketing its products in this country year after year, report losses and stay in business?

I will be paying particular attention through the hearings today and Thursday from the witnesses in terms of the automobile industry because I know that in that particular area there are billions and billions of dollars worth of products sold in this county.

It will be interesting to see if, in fact, that particular industry is paying its fair share of taxes or if, in fact, there is a scheme being used under current law to avoid taxes.

Also, Mr. Chairman, we will be listening quite closely to determine whether or not these multinationals are refusing to cooperate with investigations or the audits in terms of refusing to release information or if they use every obstacle and every procedure that they can to drag it out so that the cases just become so old that sometimes we might lose the audit trail or lose interest from the management standpoint.

I think it is a legitimate inquiry for this subcommittee to look into inasmuch as we do have fierce international competition.

We do not want one set of industries gaining a situation if, in fact, that is what has occurred. So I think the Chair is proper in calling these hearings and I look forward to the witnesses' explanation of these areas and just to tell you Mr. Chairman, I am particularly interested in the automobile section.

Chairman PICKLE. Thank you very much, Mr. Anthony.

Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. Chairman, I appreciate your interest and leadership in this rather esoteric but extremely important aspect of Federal tax policy.

I also wish to commend the subcommittee and the Joint Committee staffs for their painstaking effort to make an extremely complex body of law understandable. My political instincts tell me that we face a daunting challenge in obtaining accurate production procedures and other information from our trading partners.

The trump card we hold is our vast and unencumbered market. The testimony received this week will virtually color my judgments on further tax and trade issues. Over the long term we might have to consider fundamental changes in our laws to achieve cooperation from foreign corporations that sell products here. We must also keep in mind that we do not operate in a vacuum and our own corporations have growing overseas interests.

I look forward to hearing more detail from our witnesses today about the troubling information we have heard about the sky-rocketing gross receipts and almost nonexistent taxable income from these foreign corporations operating in the United States.

At the time when we are discussing higher taxes on Americans, we must also identify every dollar that is legitimately owed by those who have the privilege of doing business within our borders.

Thank you.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Mr. Chairman, I want to commend you, Mr. Schulze and the committee staff for moving out in this very important area. Its importance is growing dramatically.

I agree with Mr. McGrath that this area will continue to grow in importance. I hope we can make some comparisons, not only with what U.S. corporations are paying and what the foreign-owned U.S. corporations are paying, but I hope during this hearing we can state these matters in terms that the American taxpayer has a better perception of, what is his effective tax rate compared to effective rate paid by foreign-owned U.S. corporations.

Mr. Chairman, I intend to work on the electronics area in particular. I appreciate the way the chairman has divided it up so what we can all participate in it.

Thank you.

[The opening statement of Mr. Chandler was subsequently received:]

Statement of Hon. Rod Chandler

Mr. Chairman, I want to commend you for calling this series of hearings on tax underpayments by U.S. subsidiaries of foreign companies. Today, we will hear about IRS's efforts to detect the very complex income tax avoidance strategies used by foreign-owned companies, especially in the areas of automobiles, motorcycles, and electronics equipment.

We will also hear, today, from U.S. Customs officials about similar schemes to avoid Customs duties and fees, and the difficulty in detecting them. Three Customs investigators will testify on specific cases during the Executive Session, and Customs management will tell us later this afternoon about what more can be done to stop these abuses.

Mr. Chairman, we know from history that Customs collections were the primary source of Federal revenue for almost the first century of our fledgling nation's existence. Today, Customs duty collections raise over $20 billion in revenue, and are an important part of our country's trade policy. In addition, Customs user fees raise over $800 million to cover the costs of essential commercial operations. While the income tax is now by far the largest source of Federal revenue, Customs collections are still an important component of the Federal Governments' overall finances.

If certain sectors of the economy find a way to gain an unfair advantage by avoiding the proper duties and fees, it not only hurts the Federal "pocketbook", but it hurts our industrys' international competitiveness as well. That is why I am particularly concerned about reports of possible manipulation and abuse of the Canadian Free Trade agreement in connection with these schemes.

Mr. Chairman, I look forward to hearing about Customs' suggestions for changes in this area, and to the testimony from the rest of today's witnesses.

Chairman **Pickle**. Thank you.

Now our first witness will be Mr. Stuart Brown, the deputy chief of staff, representing the Joint Committee on Taxation.

Mr. Brown will you proceed?

STATEMENT OF STUART BROWN, DEPUTY CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. **Brown**. Thank you, Mr. Chairman.

This morning my testimony will concentrate on the tangible properties aspects. It will be based on the pamphlet identified as JCS 22-90.

I think the members have the pamphlet before them. I will try to refer to various pages as I go through the overview.

Let me try to describe it in simple terms of why the problem arises.

I will give an example that is based on the type of situation the subcommittee has focused on, an inbound transfer of tangible property.

Chairman Pickle. Mr. Brown, you do not have a prepared statement, as I understand?

Mr. Brown. That is correct.

Chairman Pickle. If you will speak into the mike, we will be able to hear you better.

Mr. Brown. Thank you.

I will start off by giving you an example of how the problem arises. In the inbound transfer of tangible property case you have a foreign manufacturing corporation that sells its products to a U.S. distributing corporation. The U.S. distributing corporation then reselling the products to the public or to other unrelated parties. In cases where the foreign manufacturer controls the U.S. distributor, the transfer price is set between related parties. In that circumstance, if the transfer price is too high the effect of the transaction is to shift income from the United States to the foreign country.

Having set that as an example of the type of situation the staff has looked at most carefully, I think it is important to know the situation can arise in reverse where a U.S.-owned company wants to sell products abroad. The problem can arise because the price from the U.S.-manufacturing corporation to the foreign marketing corporation might be too low and therefore the profits will be shifted outside the United States in that manner as well.

But again coming back to the example of the inbound transfer where you have a foreign manufacturing corporation and a U.S. distributing corporation that the manufacturer controls, the problem of transfer prices tends to arise when the prices are too high.

The IRS Code presently deals with that problem primarily through section 482. What the section 482 does, as the chairman said, is allow the IRS to allocate income deductions and credits between commonly controlled taxpayers. The standard that section 482 uses for making those allocations is called the arm's-length standard. This arm's-length standard is intended to allow the determination of correct taxable income of each of the parties to the transaction.

The standard is reflected in the regulations. It is also part of the U.S. model income tax treaties. The arm's-length standard appears to be at present the general international norm.

Having said that, it is recognized that there are a lot of difficulties in applying the arm's-length standard. Those are discussed primarily at pages 28 and 29 of our pamphlet. Let me just identify the two we think are most important. One has to do with availability of data.

We think that the central factor in determining the ability of the IRS to apply section 482 appropriately is its ability to obtain access to the data that it needs to do the transfer pricing analysis.

I will come back and discuss it later, what has been done, how present law addresses the data gathering issue the IRS faces. Beyond the data gathering, there is a second problem in transfer pricing cases and that is that these cases are somewhat different from a tax audit situation. Typically in tax audits the IRS is generally trying to learn facts that exist and apply the law to the facts.

In a 482 case the IRS has to go one step beyond that. It has to determine what the facts would be in a hypothetical transaction that did not actually take place in order to establish the arm's-length price.

So even if you solve the data problem, you still have the problem that these issues will be complex and difficult for the IRS to deal with.

Having said that, let me come back to the more specific description of how the regulations under section 482 deal with the arm's-length standard in the context of transfers of tangible property which is discussed on pages 7 to 10 of our pamphlet.

The regulations list four approaches for determining the appropriate transfer price under an arm's-length standard in section 482 with transfers of tangible property. The regulations specify three specific methods and then they have a fourth category.

The regulations specify that the three methods listed are described in detail and have to be applied in the priority they are listed. The first is the controlled price method which is discussed on page 8. The essence of this approach is to discover when there are comparable sales of comparable products between unrelated parties that can be used to measure an appropriate transfer price for sale between later parties.

Obviously the key question is can you get information about uncontrolled sales and can you decide that these sales are either substantially identical or that you can correct for any differences that you can identify.

The second method identified in the regulations is the resale price method. This method applies where there are no comparable sales that can be used. It is based on establishing an appropriate resale profit margin for the taxpayer in question.

It typically applies in the context of distributors of products that are purchased from a related manufacturer and resolved to unrelated parties. In applying this method the key is to decide whether or not the activities of the taxpayer in question are comparable to the activity of other taxpayers who you are using as reference points to establish an appropriate profit margin percentage.

The key to being able to make that decision is having adequate information both about the taxpayer under examination and about the markets that he is operating.

The third method is the cost profit method described on page 10. This attempts to establish an appropriate arm's-length price by looking at the costs incurred by the manufacturer of a product, the original sale of the product and adding an appropriate markup percentage to those costs in measuring what he should have charged the related initial buyer. Again this related substantial data not only about the taxpayer under examination but about the original seller's operations and costs and about the market in which both are operating.

Finally the regulations identify a fourth residual category. If none of the first three is applicable the IRS is permitted to apply another other method. In many cases these other methods have focused on financial ratios. We discussed at page 10 and 29 through 32 how these ratios are commonly developed and applied. Some examples may be return on equity, return on assets and operating costs, the so-called Berry ratio.

These methods have been used to establish transfer prices and also to check the reasonableness or accuracy of prices established under other methods. Again these ratios require the IRS to develop data about the taxpayer's specific operations and also about the operations of comparable taxpayers in comparable markets to identify what ratios are appropriate and therefore have a benchmark for establishing what ratios might be an indication of a transfer pricing problem.

I would like to specifically address your attention to the discussion on pages 31 and 32 which discusses some of the reasons we think these issues have to be dealt with very cautiously. They basically relate to the problems that you would imagine arise in developing data for making these financial ratios and comparisons.

Let me turn to the question of how the IRS applies these basic rules in practice, what the IRS enforcement mechanism is, that is on pages 14 to 17. In general the code requires all taxpayers to maintain adequate books and records and gives the IRS the authority to obtain those books and records if it needs to do so to determine the taxpayer's proper liability.

Normally these are obtained in the course of audits in fairly informal process. In corporate cases typically involving information document request, IDR's, however the code also gives the IRS the authority to use a summons power to obtain this information if it is not made available through these less formal processes.

The summons of course are subject to enforcement by the courts. These rules apply to all taxpayers. However we identify particular problems that may arise in getting this information on transfer pricing cases involving taxpayers and related parties who are outside a typical U.S. taxing jurisdiction, particularly where the information may be abroad and may be controlled by Americans who are not subject to U.S. jurisdiction generally. The documents may be in a foreign language. The information needed may be compiled under foreign accounting rules that are not readily comparable to U.S. accounting rules.

So before the 1989 act there was a fair amount of litigation about the IRS' authority to obtain information from foreign persons through the traditional information gathering processes. The leading case was the Toyota case which is discussed at page 14 of our pamphlet. I think it is fair to say that while Toyota maintained the information to be provided, there were a lot of special factors in that case so the law is somewhat unclear still for audits that are not affected by the 1989 act legislative changes. There were, however, a number of significant changes last year in the tax bill, in section 6038A which are discussed at pages 16 and 17. These apply to U.S. corporations that are more than 25 percent owned by foreign persons.

They give the IRS special authority to obtain information about these corporations' transactions with related parties. The act also increased the sanctions for failure to comply with information requests from the IRS. It made sure it provided a requirement that a persons must be available to accept service and legal process for this purpose.

Now in addition to the 1989 legislation there is legislation now pending in both houses of Congress as the Foreign Tax Equity Act of 1990 which would span these information requirements. This pending legislation is discussed on pages 16 to 17 of our pamphlet. I think some of the most important things to know about the pending legislation are that it will first extend the rules that were adopted last year to all open tax years. Last year's legislation applied only to tax years beginning after July 10, 1989, which means that for taxpayers whose audits may stretch back for 10 years, these audits would not be affected by the last year's legislation. The proposed legislation that is now pending would extend the 1989 rules to all open tax years including pending audits.

It would also extend these rules to situations where foreign corporations do business in the United States directly through a branch rather than a subsidiary. It will provide the IRS with authority to extend the the statute of litigations up to 3 years where felt it was necessary to do so. Apart from the general statutory rules and procedures for obtaining information there are also procedures provided under tax treaties for obtaining information and resolving disputes. These are discussed on pages 18 through 21.

Let me finish with a brief statement about the information the subcommittee has gathered. As the chairman knows, the Joint Committee staff assisted the subcommittee staff in obtaining information from the IRS. We will be pleased to provide whatever assistance we can in analyzing this information and seeing what it says about the questions the subcommittee is studying. I think it is important to make it clear that at this point the joint committee staff has not analyzed this data to the point necessary to express an opinion about what it says or draw conclusions about what should be done based on it.

Having said that, I hope it came across in the other part of my statement that the committee can focus on the question of whether the IRS has the ability, whether the present rules provide the IRS with adequate resources to obtain the information that it needs in carrying out these audits. We think that question should be addressed and dealt with wholly apart from anything this data may or may not show.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Brown, for your testimony and for pointing out the methods by which you measure comparable sales and the other methods and procedures.

I want to say that the committee print that you have prepared for us is very helpful because it gives us from a legal standpoint a good description of how these pricing standards are set.

I want to thank you for that and your testimony.

We are going in to other testimony. Will you be able to be with us during the day for this hearing?

Mr. BROWN. If you would like me to, sir.

Chairman PICKLE. I hope you might. Do any committee members have any specific questions.

Mr. Schulze.

Mr. SCHULZE. From a tax standpoint Mr. Brown you stated it is burdensome on the IRS and other agencies, but if we did have a border tax similar to that which is utilized in most European countries, so that when a product crosses the border, it automatically pays a tax such as a value added tax, then if the parent corporation increased the prices in order to avoid taxation in a specific country, wouldn't the country benefit by receiving a higher amount of tax? Wouldn't it be much more difficult to avoid not only the documentation but also the payment of taxes?

Mr. BROWN. Mr. Schulze, I think it is clear that a value added tax of that type could raise substantial revenue generally and perhaps from imported products as well. I am not sure it would be a complete solution to this problem.

Mr. SCHULZE. I don't believe it is a complete solution and I am not proposing it as such but wouldn't it create a mandatory paper trail on dollar amounts and taxes paid? There would be no way to avoid the payment of that tax?

Mr. BROWN. To avoid the payment of the border tax?

Mr. SCHULZE. Exactly.

Mr. BROWN. I would assume that you could enforce a border tax under some mechanism.

Mr. SCHULZE. If somebody tried to avoid the payment of taxation in this country by increasing the prices such as transfer pricing, they would pay more taxes as they came across the border and it would not be a successful tax avoidance scheme.

Mr. BROWN. A border tax in that manner could result in a countervailing incentive in terms of price setting. The higher the price, the higher the border tax. Section 482 issues a rise in reverse as well. So it would not be a complete solution. I would point out the fact that many countries that do have such taxes have similar problems under 482.

Mr. SCHULZE. I believe we are the last major exporting country in the world that does not have that tax, but our products pay those taxes all around the world.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Mr. Brown you made reference to the arm's length pricing methods. You are not recommending a change from that?

Mr. BROWN. No.

Mr. FLIPPO. You talked about the three methods used to determine transfer pricing. I believe that IRS applies those methods with priorities.

Mr. BROWN. The regulations establish the priorities.

Mr. FLIPPO. Do you have any recommendation for the committee with regard to the priorities established by the IRS regulations to determine those pricing mechanisms?

Mr. BROWN. I don't, Mr. Flippo. Let me say with regard to that question and your previous questions, when we say we have no recommendations, I do not mean to imply that we recommend no change should be made. I simply mean we have not focused on whether such changes should be made.

Mr. FLIPPO. Thank you.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Mr. Brown, the burden of proof is on the taxpayer under out tax system, why then is it so difficult for the IRS to administer the transfer pricing rules and why isn't it the burden of the taxpayer to prove that its transfer prices were correct?

Mr. BROWN. I think clearly you are correct that the burden of proof is on the taxpayer, however the burden of proof can be a difficult concept to apply when that is the only issue before a court in making a decision.

In other words a taxpayer can provide the information that it believes serves its interest and thereby have established the burden of going forward with the evidence and yet there may be more information that is not being presented to the court and that is not available to the IRS that would lead to a different conclusion than you would reach if you look solely at the information the taxpayer chooses to present.

I think the critical point is to be sure that the IRS and the courts have access to all relevant information in order to then balance the decision.

Mr. McGRATH. It would seem to me then that it would be perhaps practical to require the companies to detail as an addendum to their tax return how they arrived at their pricing. Would that be helpful?

Mr. BROWN. I think that is a question that really the IRS should answer. I think certainly we would recommend giving the IRS the tools it needs to obtain the information it believes should be considered in determining these cases.

I don't think it is best for us to try to specify exactly what information should be obtained or how it should be obtained in terms of whether we should report on a tax return or provide separately or what.

Mr. McGRATH. Thank you.

Chairman PICKLE. I thank you, Mr. McGrath.

Mr. Brown, I thank you very much for your testimony and the compilation of this very important pamphlet.

Thank you very much.

Mr. BROWN. Thank you, Mr. Chairman.

Chairman PICKLE. Now the Chair would ask Mr. Patrick Heck, Russlyn Guritz, Tom Arnold, and Michael Superata if they would take their seats at the witness table.

For several months the Oversight Subcommittee staff has been looking into this question of taxes paid by foreign controlled subsidiaries.

Mr. Patrick Heck will be presenting testimony on behalf of the staff and others may be making statements or comment. Before you proceed, Mr. Heck, I want to say our committee appreciates the thorough examination and investigative efforts that you have made in compiling these facts. I believe it is the most comprehensive and thorough examination of this question that we have ever had. It is invaluable testimony.

I thank you all for a thorough job. I know this required the staff going out into the United States to numerous IRS offices to examine many corporate tax records.

I want to thank you now. Mr. Heck will proceed with the testimony. I recognize that you have a rather lengthy statement but it represents the thoroughness of this investigation. Is that the procedure you would like to follow?

STATEMENTS OF PATRICK G. HECK, ASSISTANT COUNSEL, RUSSLYN GURITZ, COUNSEL, THOMAS ARNOLD, ASSISTANT COUNSEL, AND MICHAEL SUPERATA, MINORITY COUNSEL, SUBCOMMITTEE ON OVERSIGHT

Mr. HECK. Yes, Mr. Chairman. On behalf of the staff I want to thank you for your comments.

Good morning. It is a pleasure to be here today to present the results of the subcommittee's staff investigation on the level of tax payments by foreign-owned U.S. companies and other compliance issues. With me this morning are Rusty Guritz, Michael Superata, and Thomas Arnold who assisted in the staff investigation. In an effort to save time I will summarize as much as possible.

The subcommittee's investigation was conducted over the last 9 months and specifically focused on 36 foreign-owned U.S. distributors of automobiles, motorcycles, and electronics equipment. These are U.S. incorporated companies that distribute foreign-made products to U.S. wholesalers and retailers for the American consumer.

For years, allegations have been made that a significant number of foreign multinationals were charging their U.S. subsidiaries inflated prices for manufactured goods and various fees to reduce their taxable income in the United States. It is well established that, through intercompany pricing, multinational corporations can significantly affect the amount of taxes they pay or don't pay. Analyses of IRS statistics of income (SOI) data have typically been used to confirm or deny the existence of a compliance problem in this area. No one, however, has thoroughly looked behind the aggregate SOI numbers to determine if, in fact, foreign-owned companies were underpaying U.S. taxes and, if so, the extent of the problem and how it is being done. That is until now.

The companies we investigated were selected by staff because they have extensive business operations in the United States that, over the years, have generated substantial gross receipts from the sale of high-priced consumer products, like automobiles, trucks, motorcycles, televisions, stereos, VCR's, and FAX machines.

Our investigation involved face-to-face interviews with over 100 individuals including IRS National Office and field personnel, economists, former IRS Commissioners, and other international tax law experts. When interviewing IRS employees, we had them describe the specific cases they examined and the problems they encountered in detecting income shifting and developing transfer pricing cases. We inquired about the examination process and the audit tools they utilized; the problems associated with obtaining access to critical information needed to develop these complex cases, such as, foreign-based manufacturing cost and product-line data; the level of cooperation received from the companies; and the support given to the field by the IRS National Office.

We reviewed and analyzed thousands of confidential documents. We inspected over 200 corporate Federal income tax returns, voluminous case files, and other nondiscloseable tax and Customs records. We reviewed interoffice communications detailing IRS positions with regard to case administration, audit issues, proposed adjustments, and settlement positions. As a result, the subcommittee complied an extensive and revealing collection of documents relating to the companies reviewed. We were able to analyze these materials as a whole, in a systematic manner that has never been done before—even by the IRS.

Our mission was fact finding, pure and simple. We were asked to find out whether these corporations were paying what is required under the Federal tax laws. To the extent these companies underpaid taxes, we were instructed to determine how this was being done, and how successful the IRS was in detecting, pursuing, and collecting this revenue. As a result of this investigation, the following is known.

Chairman PICKLE. Mr. Heck, will you allow me to interrupt you at that point before you proceed with your summary? The subcommittee will go into closed session, anticipating the vote, at the conclusion of this testimony to receive and review tax return information from Internal Revenue Service. This information is subject to strict rules of confidentiality imposed by statute on the IRS under statute 6103. This information cannot be disclosed in public to persons not authorized by statute. The subcommittee will resume the public portion of the hearing around 1, to receive publicly discloseable statements from the IRS Commissioner and field agents. I believe we have a quorum here. We will have to take a vote. Mr. Anthony.

Mr. ANTHONY. Mr. Chairman, I move that the subcommittee go into closed session at the end of this testimony in order to receive tax information required by IRS section 6103 and the committee rules.

Chairman PICKLE. Mr. Anthony moves we go into closed session at the end of this testimony. Those in favor will say aye when their name is called.

The CLERK. Mr. Anthony.

Mr. ANTHONY. Aye.

The CLERK. Mr. Flippo.

Mr. FLIPPO. Aye.

The CLERK. Mr. Dorgan.

[No response.]

The CLERK. Mr. Ford.

[No response.]

The CLERK. Mr. Rangel.

Mr. RANGEL. Aye.

The CLERK. Mr. Jacobs.

[No response.]

The CLERK. Mr. Schulze.

Mr. SCHULZE. Aye.

The CLERK. Mr. McGrath.

Mr. MCGRATH. Aye.

The CLERK. Mr. Chandler.

[No response.]

The CLERK. Mr. Shaw.

[No response.]

The CLERK. Mr. Pickle.

Chairman PICKLE. Aye.

The CLERK. Mr. Chairman, the ayes have it.

Chairman PICKLE. Accordingly, the motion carries and we will go into closed session at the end of this testimony.

Mr. Heck, you were at a point now where you are going to summarize.

Mr. Heck. Yes, Mr. Chairman.

As a result of the subcommittee's 9-month investigation, the following is known. One, more than half of the 36 companies we investigated paid little or no Federal income tax.

Chairman Pickle. Say that again now?

Mr. Heck. More than half of the 36 companies we investigated have paid little or no Federal income tax. Two, the major international tax issue before the IRS is transfer taxing. In cases we reviewed, the transfer pricing issue involved the foreign subsidiary paying too high a price for the goods it purchased from its overseas parent. This resulted in a lower level of taxable profit in the United States.

Three, the companies investigated also used other methods to shift income from the United States, including excessive freight, insurance, interest, and other fees or charges.

Four, IRS' international enforcement program suffers from a lack of coordination, retention of experienced personnel, and resources. Simply put, "the IRS is outgunned."

Five, transfer pricing cases are difficult to examine because the issues are factual, complex, and some companies deliberately refuse to provide the IRS with the necessary information.

Foreign-owned subsidiaries have engaged in duty-avoidance schemes involving illegal freight and insurance charges, kickbacks, and manipulation of prices for products traded between subsidiaries operating in the United States and other countries.

Now let me go into each of these six conclusions in more detail. We looked at the tax returns and level of tax payments of 36 foreign-owned companies over a 10-year period. This enabled us to track their corporate tax payments, from year to year.

We discovered that more than half of the foreign-owned companies reviewed paid little or no Federal income tax.

At the same time, these firms handled billions in gross sales distributing foreign-made products for their foreign parents. According to the IRS, a closer look at these companies shows that their poor profit performance is hardly attributable to inefficient management. Rather the inflated pricing of goods purchased from the foreign parent, or the performance of functions not properly compensated for by the foreign parent, appear to be the main causes for the low lever of U.S. profits and corporate tax payments.

We did find that while most of the 36 foreign-owned companies engaged in questionable transfer pricing practices, there were some companies that paid Federal income tax. The IRS examined these companies and found their transfer pricing structures met the required arm's-length standard. To illustrate the differences in the level of tax payments, we identified two foreign-owned U.S. electronics distributors with similar product-lines, distribution operations, assets, gross receipts, and dates of incorporation in the United States. One electronics company paid Federal income taxes over a 6-year period of over $150 million while the other paid no tax at all. The IRS will quickly point out that transfer pricing typically explains the differences among foreign subsidiaries in their tax reporting practices.

Chairman PICKLE. Are those two companies of comparable size?

Mr. HECK. Yes, sir.

The IRS also explains that even though some of the companies reviewed did pay some tax in some years, these tax payments were often negated by net operating loss carry-backs from later years. For example, in one case, a foreign-owned distributor paid more Federal income tax each year as its sales increased and gross receipts grew.

However, after a couple of years of reporting corporate income tax payments, the distributor suddenly incurred substantial losses. These losses allowed the company to recoup taxes previously paid in addition to offsetting the current year tax liability.

The losses were the direct result of increased deductions for advertising, sales promotions, and other marketing incentive programs, expenses which should have been reflected in lower transfer prices. According to the IRS, this type of profit/loss scenario is not unique. The perception is that many companies deliberately plan profits in cycles to take advantage of subsequent year net operating losses.

The subcommittee looked at one electronics company, described by IRS agents as "a very aggressive and egregious taxpayer." With gross receipts totaling almost $4 billion for a 7-year period, the company reported only $15 million in tax liabilities. The IRS looked at the company's tax returns for more than 10 years and found that, even where there might have been profits reported, the company always had net operating losses available to zero out any tax. In 10 years, this company ultimately paid no Federal income tax.

Chairman PICKLE. You say that in 10 years this company ultimately paid no Federal income tax. You stated prior to that that according to the IRS this type of profit and loss scenario is not unique and that the perception is that many companies deliberately plan profits in cycles to take advantage of subsequent year net operating losses.

Is that the general pattern with many of these companies?

Mr. HECK. According to our investigation and according to the people we have talked to at the IRS, yes.

Chairman PICKLE. We want to receive other testimony on that point later so go right ahead.

Mr. HECK. In a case currently pending in the Tax Court, the public documents show that for tax years 1980 through 1984, the Japanese company reported $5,272 in taxes due. The statutory notice of deficiency issued by the IRS asserts that the company should have paid $127 million in taxes, for these years. In 1982 alone, the company paid just $123 in taxes, while the IRS claims the company should have paid $27 million. The IRS is alleging that the company understated its gross profits by almost $500 million due to the overpricing of the goods sold.

Chairman PICKLE. Is that case closed?

Mr. HECK. That case is currently pending in the U.S. Tax Court.

We reviewed 106 Federal tax returns obtained from the IRS regarding the 18 electronics distributors. On these returns, the companies reported $116 billion in gross receipts and paid only $654 million, or one-half of 1 percent in Federal income tax.

Over 10 years, only nine companies reported positive taxable income. For 1987 alone, 14 out of the 18 electronic companies reported $20 billion in gross receipts and paid only $38 million, or slightly less than two-tenths of 1 percent in Federal income tax.

The $38 million is more than the Federal Government actually received, however, since the figure does not reflect net operating loss carrybacks. Eight of these companies reported almost $14 billion in gross receipts and paid no Federal income tax. Had these companies paid just 1 percent of gross receipts in taxes, the Federal Treasury would have collected $140 million.

We also reviewed 116 Federal income tax returns regarding the 18 automobile and motorcycle companies. In the returns reviewed, all but two companies paid some Federal income taxes. However, the IRS indicated that, with net operating loss carrybacks, only 12 companies actually paid tax. For tax year 1987, 10 companies reported $38 billion in gross receipts and paid only $366 million in Federal income tax, or less than 1 percent. When net operating loss carrybacks are factored, in the amount actually paid in 1987 is significantly less than 1 percent.

It is through improper transfer pricing that most of these foreign-owned companies were able to reduce their U.S. tax liabilities. In most of the cases, the transfer pricing issue was pretty straightforward. Due to the foreign parent's control, the price charged by the parent to its subsidiary is set independent of market forces, and is often substantially higher than prices set during an arm's-length negotiation.

In the cases we reviewed, for instance, a foreign parent sold television sets to an unrelated distributor for $150, while its subsidiary paid $250 for the same model. An automobile manufacturer shipped trucks to its U.S. subsidiary at prices higher than that paid for identical trucks shipped to an unrelated U.S. distributor. One foreign automobile manufacturer sold cars to its U.S. distributor at prices averaging $800 more than identical cars shipped to its Canadian distributor. Still another foreign-owned U.S. distributor paid substantially higher prices for its cars primarily because the manufacturer's European distributor was losing money. In the above cases, the prices paid by these companies did not reflect arm's-length pricing, the standard required under the U.S. law.

In determining an arm's-length transfer price, the IRS must consider such factors as rebates, warranties, advertising expenses, and fluctuations in foreign currencies. For instance, in many automobile cases, the IRS focused on the use of rebates. Generally rebates are utilized by automobile manufacturers to help dealers sell new cars. According to the IRS, the use of rebates by foreign-owned manufacturers often is not reflected in the transfer price paid by its U.S. subsidiaries.

Distributors operating at arm's-length would not purchase automobiles from a manufacturer at a price that does not take into consideration rebates. The IRS contends, that since the manufacturer is directly or primarily affected by the sale of the year end new cars, the rebates are directly or primarily the expense of the manufacturer and should be considered as such in determining the transfer price.

The question being asked by IRS agents is "why should the U.S. Government be subsidizing the promotional activities of foreign car manufacturers?" The U.S. Government does subsidize these rebates to the extent that inflated prices paid by U.S. companies reduce the profits that are taxed in the United States.

Other methods frequently used by U.S. subsidiaries to reduce their tax liability involve the allocation of advertising expenses and warranty costs. Here expenses for advertising and warranty costs are borne by the related distributor with no corresponding price concession from the foreign parent. In an arm's-length transaction between unrelated parties, a distributor would not bear the burden of advertising and warranty expenses without securing a corresponding price reduction in the costs of goods sold. In one case, the advertising expenses exceeded 50 percent of the company's gross profit, whereas the industry, in general, spent between 3 to 5 percent of gross profits on advertising.

There are other mechanisms, in addition to transfer pricing, which allow foreign multinationals to shift income out of the United States. Through the use of fees, multinationals can charge their U.S. subsidiaries exorbitant insurance, interest, and freight costs. These fees are routinely dictated to the U.S. companies by foreign multinationals and are seldom the product of negotiation.

One example of how foreign parent companies can shift or "skim" profits is by overcharging for ocean freight. These inflated fees inappropriately increase the price the U.S. subsidiary pays for the products it imports. In some instances, we found that foreign manufacturers shipped to their U.S. subsidiaries merchandise identical to that shipped to unrelated distributors. The manufacturer, or its shipping subsidiary, would charge its U.S. distributor more in freight charges than the amount billed to the unrelated company for identical merchandise carried on the same vessel, arriving on the same day, to the same port.

The IRS employees interviewed during the investigation are very dedicated and competent professionals. A major problem is the IRS's level of staffing in relation to the growth in the international area. The number of foreign-owned corporate income tax returns filed increased from 20,000 in 1980 to 45,000 in 1987. International staffing increased from approximately 200 international examiners in 1980 to almost 500 positions in 1990. Despite the increase in staffing, the IRS does not currently have a system in place to determine the optimal staffing needs or measure the effectiveness of its compliance programs. For example, the IRS could not even provide us with information concerning the marginal rate of return on section 482 examinations.

As one IRS agent put it, "the agency is outgunned." In one case, the examination team tried to get an IRS economist assigned to the project for 8 months. Once an IRS economist was assigned, he advised the international examiner that for budgetary reasons he would not be coming out to the field to actually work the case, but asked the examiner to give him a call if the agent found something. The IRS cut corners in this case while the company was represented by a prominent accounting firm and an experienced international tax attorney.

According to the IRS, attorneys from major law firms constantly brag to international examiners that IRS audits of foreign-owned subsidiaries "mean millions in fees to the firms." At the same time, experienced IRS agents and attorneys are leaving the agency daily for better paying jobs. In all the discussions we had with the IRS employees, the question of Federal pay figured prominently.

State and county governments pay their senior attorneys significantly more than the Federal Government. For instance, Orange County, Calif., pays its attorneys almost $20,000 more a year than the IRS pays its most senior and seasoned attorneys.

The successful development, resolution, and litigation of section 482 cases requires a complex and thorough economic analysis of the involved transactions. The IRS has only 40 economists worldwide; a single major accounting firm employees at least as many for its clients. Economic experts must be highly credible and able to articulate their conclusions. We found, however, that these IRS economists face a number of serious obstacles.

Many IRS economists do not have Ph.D.'s, have not extensively published in their field, and have not testified in court. If IRS economists do testify, they are often perceived by the courts to be biased in favor of the IRS. Outside economists usually have prior litigation experience, are widely published, and are generally considered to be leaders in their field.

They charge between $150 and $450 an hour. On the other hand, IRS economists are paid approximately $44,000 a year, or about $20 an hour. According to the IRS, it is often difficult to retain experienced economists at this salary. Despite this fact, the IRS recently downgraded the salaries of their economists.

The IRS economists do not have many of the resources that exist for outside experts. For example, outside economists have access to information data bases which the IRS does not provide to its economists. IRS economists must develop their economic analyses case-by-case with time consuming research in libraries. The IRS has also reduced its international training and eliminated its participation in international section 482 conferences.

The IRS must go through a burdensome administrative procurement process to hire outside experts. While corporations can hire experts instantaneously the IRS must go through a competitive bidding process. One one case, it took the IRS several months to hire an outside economist. Even if the IRS goes through the protracted hiring process, it has faced other hurdles. We learned that an American university encouraged its professor to avoid working with the IRS for fear of losing corporate contributions.

The IRS has prematurely closed examinations because of internal pressures to dispose of cases early. Some transfer pricing audits are limited to single product lines because the IRS does not have the time or resources to do comprehensive examinations. In some cases, transfer pricing issues are avoided because they are too unmanageable and would not produce significant revenues.

The IRS does not effectively coordinate the handling of international tax issues. Each case involving section 482 is handled separately. International examiners do not communicate with each other regarding the development of common issues or the sharing of industry data. Many of the transfer pricing schemes are similar in nature, but the IRS must reinvent the wheel each time an examination is conducted.

Further, under existing procedures, IRS examiners are required to use certain pricing methodologies in a prescribed order. Some IRS international examiners objected to the rigidness of the procedures and believe the process needs more flexibility.

In essence, the IRS' international enforcement program suffers from the lack of resources and coordination. It is hamstrung by bureaucratic red tape, whether it is the procurement of experts or being handcuffed by the regulations that prioritize pricing methodologies. The IRS' internal problems are further exacerbated by the difficulties encountered with the taxpayers.

The corporate community has developed what the IRS agents term, combat strategies. A document we obtained reveals that corporations are instructed to avoid retaining nonprivileged documents that do not support, or that might contradict, tax positions taken or that could serve as a road map for audit if obtained by the IRS.

The document goes on to instruct companies on when to refuse to extend the statute of limitations and how to respond, or avoid responding, to IRS requests for information.

The foreign-owned companies reviewed are represented by the best legal talent the United States has to offer. These companies often hire outside experts just to keep them away from the IRS. The companies talk to one another keeping each apprised of IRS audit techniques and issues raised. According to the IRS, if one company begins to take advantage of a tax issue, the entire industry begins to do likewise.

We found that it usually takes 10 years to complete an automobile audit, 4 to 6 years for a motorcycle or electronics equipment case. In almost all of the cases reviewed, the IRS agents reported that the difficulties encountered in obtaining information from the taxpayers makes for a long, drawnout process. In many instances, the attorneys representing these companies prolong the resolution of these tax disputes by spoon feeding the IRS information. Delay results in fewer audits and ineffective enforcement.

According to the IRS, it has closed examinations without proposing any adjustments because the company was uncooperative and the IRS was unable to get the necessary information to work the transfer pricing issue. In one case, the company refused to provide foreign-based information claiming "we aren't required to keep such records by law in our home country." In another case, the company took a different approach, providing the IRS with 40 boxes of documentation without an index, in essence, burying the critical data in a mountain of useless paper. One company selectively provided the IRS with all facsimiles generated throughout the year, except those sent around the time the foreign parent raised its prices. According to the IRS, those documents were conveniently missing.

We learned that there are other Federal agencies that receive information from foreign multinationals which would be useful in conducting transfer pricing audits. For instance, the Commerce Department collects foreign-based data during its antidumping enforcement efforts. Commerce questionnaires soliciting cost and pricing information are received from foreign companies but are not disclosed to other Federal agencies, including the IRS. Similarly, the Customs Service conducts importation and duty investigations but does not routinely share the information collected with the IRS. Federal disclosure laws are often cited as reasons for agencies refusing to exchange data.

During the course of the investigation, we became aware of several duty-avoidance schemes engaged in by foreign subsidiaries operating in the United States. In one of these cases, the overstatement of freight and insurance costs on imported products were used to avoid both tax and duty. Since the IRS and Customs do not coordinate their investigative findings very well, it is questionable whether these companies were assessed additional amounts for both.

The first scheme involves freight and insurance costs of the importer which are nondutiable charges. The overstatement of nondutiable charges fraudulently decreases the dutiable value of imported products and, therefore, the amount of duty paid. Since freight and insurance charges are also deductible business expenses, they decrease the amount of taxes paid.

Customs has found through its "Operation RAP"—rebate and adjustment program—that numerous international freight and insurance companies are charging for freight and insurance on paper to the importing subsidiaries, and then playing kickbacks to the firms in the form of cash or money orders. For example, invoices filed with Customs by the subsidiary show freight and insurance charges at the higher rate without reflecting the kickbacks. The subsidiary then deducts the larger figure from the price when calculating the amount of duty owned.

Customs reports that the catalyst for Operation RAP was a Customs investigation of a Japanese automobile manufacturer. In this case, the freight company and the U.S. distributor were all subsidiaries of the foreign company. In the end, the company agreed to pay Customs over $6 million in additional duties and penalties. Since then, Customs has collected another $3 million in additional duties and penalties from foreign-owned subsidiaries of multinationals for overstating freight and insurance charges and continues to investigate a substantial number of foreign-owned subsidiaries suspected of engaging in this scheme.

In another case, Customs has found that a foreign-owned automobile manufacturer may have taken advantage of a number of complex trade laws to avoid paying any duty on automobiles sold in the United States. In this case, which was uncovered as part of "Operation Tin Lizzie," the finished automobiles were imported from Canada. At that point, the manufacturer claimed that the automobiles were duty free under the recent Canada Free-Trade Agreement because they have more than 50 percent North American content. However, upon closer examination, it appears that only a handful of the parts in the automobile were actually North American.

One part, the engine, which accounts for a substantial portion of the value that the manufacturer claimed to be North American, was assembled in the United States from foreign parts by a subsidiary of the Foreign manufacturer. Because the engine-assembly subsidiary was importing only parts and then exporting a finished engine to Canada, U.S. trade laws allowed the manufacturer to claim that the engine was made in the United States. However, Customs has two problems with this scheme.

First, the manufacturer is claiming a refund of the duties paid on the foreign engine parts when the furnished engines are exported to Canada. In Customs' opinion, this claim is illegal because the manufacturer is later claiming the engines as U.S.-made when they are reimported into the United States as part of a finished automobile.

More importantly, Customs believes that the value claimed by the manufacturer for the engine when calculating the percentage of North American content in the finished automobile is overstated and that the automobiles do not qualify for duty-free status.

The price that the Canadian subsidiary of the foreign manufacturer paid to the U.S. engine-assembly subsidiary was inflated by just enough to bring the percentage of North American content up to the point needed to quality the entire finished automobile for duty-free status upon entry into the United States.

Mr. Chairman, this concludes our statement.

[The prepared statement follows:]

STATEMENT OF PATRICK G. HECK
ASSISTANT COUNSEL
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
TUESDAY, JULY 10, 1990

Good morning, Mr. Chairman, it is a pleasure to be here today to present the results of the Subcommittee's staff investigation on the level of tax payments by foreign-owned U.S. companies and other compliance issues. With me this morning are Rusty Guritz, Michael Superata, and Thomas Arnold who assisted in the staff investigation.

SCOPE OF INVESTIGATION:

The Subcommittee's investigation was conducted over the last nine months and specifically focused on thirty-six foreign-owned U.S. distributors of automobiles, motorcycles, and electronics equipment. These are U.S. incorporated companies that distribute foreign-made products to U.S. wholesalers and retailers for the American consumer. The thirty-six companies included eighteen electronic distributors and eighteen automobile and motorcycle distributors. Out of these companies, twenty-five are subsidiaries controlled by Pacific Rim multinational corporations and eleven European parents.

For years, allegations have been made that a significant number of foreign multinationals were charging their U.S. subsidiaries inflated prices for manufactured goods and various fees to reduce their taxable income in the U.S. It is well established that, through intercompany pricing, multinational corporations can significantly affect the amount of taxes they pay or don't pay. Analyses of IRS statistics of income (SOI) data have typically been used to confirm or deny the existence of a compliance problem in this area. No one, however, has thoroughly looked behind the aggregate IRS (SOI) numbers to determine if, in fact, foreign-owned companies were underpaying U.S. taxes and, if so, the extent of the problem and how it is being done. That is until now.

The companies investigated by the Subcommittee were selected by staff because they have extensive business operations in the U.S. that, over the years, have generated substantial gross receipts from the sale of high-priced consumer products, like automobiles, trucks, motorcycles, televisions, stereos, VCRs, FAX machines, and microwave ovens. These companies are also a primary focus of the Internal Revenue Service's international enforcement efforts.

The Subcommittee's investigation involved face-to-face interviews with over 100 individuals including IRS field personnel and National Office employees, economists, former IRS Commissioners, and other international tax law experts. When interviewing IRS employees, we had them describe the specific cases they examined and the problems they encountered, internally and externally, in detecting income shifting and developing transfer pricing cases. We inquired about the examination process and the audit tools they utilized; the problems associated with obtaining access to critical information needed to develop these complex cases: such as, foreign-based manufacturing cost and product-line data; the level of cooperation from the companies; and, the support given to the field by the IRS National Office.

The Subcommittee staff reviewed and analyzed thousands of confidential documents. We inspected over two hundred corporate Federal income tax returns, voluminous case files, and other nondiscloseable tax and Customs records. We did not contact representatives of the companies we reviewed; however, we did respond to their general inquiries about the nature and scope of our investigation and this hearing. We carefully reviewed their correspondence and submissions to the IRS which were contained in the IRS case files and other materials obtained by IRS from U.S.-owned firms, Customs, and the Department of Commerce. We reviewed inter-office communications detailing IRS positions with regard to case administration, audit issues, proposed adjustments, and settlement positions. As a result, the Subcommittee compiled an extensive and revealing collection of documents relating to the companies reviewed. The staff was able to analyze these materials as a whole, in a systematic manner that has never been done before -- even by the IRS.

The Subcommittee staff's mission was fact-finding, pure and simple. We were asked to find out whether these corporations were paying what is required under the Federal tax laws. To the extent these companies underpaid taxes, we were instructed to determine how this was being done, and how successful the IRS was in detecting, pursuing, and collecting this revenue.

SUMMARY:

As a result of the Subcommittee's investigation, we will discuss the following:

I) LEVEL OF TAX PAYMENTS BY FOREIGN-OWNED U.S. SUBSIDIARIES:

More than half of the 36 companies investigated by the Subcommittee have paid little or no Federal income tax.

II) MAGNITUDE OF TRANSFER PRICING ISSUE:

The major international tax issue before the IRS is section 482 transfer pricing. In cases reviewed, the transfer pricing issue involved the foreign subsidiary paying too high a price for goods it purchased from its overseas parent. This resulted in a lower level of taxable profit in the U.S.

III) FREIGHT, INSURANCE, INTEREST, AND OTHER FEES OR CHARGES:

The companies investigated by the Subcommittee used various methods to shift income from the U.S. through excessive freight, insurance, interest, and other fees or charges.

IV) IRS INTERNATIONAL ENFORCEMENT PROGRAM:

IRS's international enforcement program suffers from a lack of coordination, retention of experienced personnel, and resources. The IRS is "outgunned".

V) IRS PROBLEMS IN OBTAINING INFORMATION:

Transfer pricing cases are difficult to examine because the issues are factual, complex and some companies deliberately refuse to provide the IRS with the necessary information.

VI) AVOIDANCE OF CUSTOMS DUTIES:

Foreign-owned subsidiaries, including companies reviewed by the Subcommittee, have engaged in duty-avoidance schemes involving illegal freight and insurance charges, kickbacks, and manipulation of prices for products traded between subsidiaries operating in the U.S. and other countries.

The following discusses thse six areas in more detail.

I. LEVEL OF TAX PAYMENTS BY FOREIGN-OWNED U.S. SUBSIDIARIES:

The Subcommittee looked at the tax returns and level of tax payments of these thirty-six foreign-owned companies over a ten year period. This enabled the Subcommittee staff to track their corporate tax payments, year to year, which is not done by the IRS. The staff investigation found that more than half of the foreign-owned companies reviewed paid little or no Federal income tax. At the same time, these firms handled billions in gross sales distributing foreign-made products for their foreign parents. According to the IRS, a closer look at these companies shows that their poor profit performance is hardly attributable to inefficient management. Rather, the inflated pricing of goods purchased from the foreign parent, or the performance of functions not properly compensated for by the foreign parent, appear to be the main causes for the low level of U.S. profits and corporate tax payments.

The Subcommittee staff found that while most of the thirty-six foreign-owned companies engaged in questionable transfer pricing practices, there were some companies that paid a significant amount of Federal income tax. The IRS examined these companies and found their transfer pricing structures met the required arm's length standard. To illustrate the differences in the level of tax payments, the Subcommittee staff identified two foreign-owned U.S. electronics distributors with similar product-lines, distribution operations, assets, gross receipts, and dates of incorporation in the U.S. One electronics company paid Federal income taxes, over a six-year period ,of over $150 million while the other paid no tax. The IRS will quickly point out that transfer pricing typically explains the differences among foreign subsidiaries in their tax reporting practices.

The IRS also explained that even though some of the companies reviewed did pay taxes in some years, these tax payments were often negated by net operating loss carrybacks from later years. For example, in one case, a foreign-owned distributor paid more Federal income tax each year as its sales increased and gross receipts grew. However, after a couple of years of reporting corporate income tax payments, the distributor suddenly incurred substantial losses. These losses allowed the company to recoup taxes previously paid in addition to offsetting the current year tax liability. The losses were the direct result of increased deductions for advertising, sales promotions, and other marketing incentive programs. According to the IRS this type of profit/loss scenario is not unique; the perception is that many companies deliberately plan profits in cycles to take advantage of subsequent year net operating losses. There seems to be a pattern.

The Subcommittee looked at one electronics company, described by IRS agents as a "very aggressive and egregious taxpayer". With gross receipts totalling almost $4 billion for a seven-year period, the company reported $15 million in tax liabilities. The IRS looked at the company's tax returns for more than ten years and found that, even where there might have been profits, the company always had net operating losses available to zero out any tax. In ten years, this company ultimately paid no Federal income tax.

In one court case, Yamaha Motor Corporation v. Commissioner, Tax Court Docket No. 2674-88, the public documents showed that for tax years 1980 through 1984, the company reported $5,272 in taxes due. The statutory notice of deficiency issued by the IRS asserts, for these years, that the company should have paid $127 million in taxes. In 1982 alone, the company paid $123 in taxes while the IRS claims the company should have paid $27 million. The IRS is alleging that Yamaha understated its gross profits by almost $500 million due to the overpricing of the goods sold.

The attachment to this statement is a compilation of selected tax return data taken from the returns reviewed by the Subcommittee for 1979-89. (IRS did not provide all tax returns for this time period.)

The Subcommittee staff reviewed 106 Federal income tax returns obtained from the IRS regarding the eighteen electronics distributors. On these returns, the companies reported $116 billion in gross receipts and paid $654 million, or .5% in Federal income tax. Over ten years, only nine companies reported positive taxable income. For 1987 alone, fourteen out of the eighteen electronics companies reported $20 billion in gross receipts and paid $38 million, or slightly less than .2%, in Federal income tax. The $38 million is more than the Federal government actually received because the figure does not reflect net operating loss carrybacks. Eight of these companies reported almost $14 billion in gross receipts and paid no Federal income taxes. Had these eight companies paid just one percent of gross receipts in taxes, the Federal Treasury would have received $140 million.

The Subcommittee staff reviewed 116 Federal income tax returns regarding the eighteen automobile and motorcycle companies. All but two companies paid some Federal income taxes. However, the IRS indicated that, with net operating loss carrybacks, only twelve companies actually paid taxes. For tax year 1987, ten companies reported $38 billion in gross receipts and paid $366 million in Federal income taxes, or less than one percent. When net operating loss carrybacks are factored in, the amount actually paid in 1987 is significantly less than one percent.

The Subcommittee obtained information on the agency's international enforcement program. According to the IRS, the agency closed a total of twenty-five hundred international cases in 1989 and proposed more than $7 billion in section 482 adjustments. Forty-two cases accounted for more than $4.5 billion, or sixty-four percent of the total.

With regard to the automobile/motorcycle cases reviewed by the Subcommittee, the IRS has proposed within the last ten years $2.5 billion in adjustments. More than $1.5 billion is related to two companies. As a result of the Appeals and Competent Authority processes, the IRS sustained approximately $1 billion. More than ninety-nine percent of the amount sustained related to a settlement by two companies. The interest paid on these two settlements was later claimed as a deduction on subsequent returns, generating huge net operating losses. According to the IRS, this will allow one of the companies to avoid U.S. taxes for years to come. The IRS has proposed more than $114 million in adjustments against eight electronics companies. Three of the companies had adjustments of over $20 million each.

II. MAGNITUDE OF TRANSFER PRICING ISSUE:

Typically, the transfer pricing issue in the cases reviewed by the Subcommittee is straightforward. A foreign corporation manufactures a product, like a car or television set, which it then sells to its wholly-owned U.S. subsidiary. The subsidiary, in turn, sells the product to unrelated third parties, such as dealerships, retailers, or other wholesalers. Due to the foreign parent's control of its subsidiary, the price which is charged by the parent to its subsidiary is set independent of market forces, and is often substantially higher than prices set during an arm's length negotiation.

In the cases reviewed by the Subcommittee, for instance, a foreign parent sold television sets to an unrelated distributor for $150, while its subsidiary paid $250 for the same model. An automobile manufacturer shipped trucks to its U.S. subsidiary at prices higher than that paid for identical trucks shipped to an unrelated U.S. distributor. One foreign automobile manufacturer sold cars to its U.S. distributor at prices averaging $800 more than identical cars shipped to its Canadian distributor. Still another foreign-owned U.S. distributor paid substantially higher prices for its cars primarily because the manufacturer's European distributor was losing money. In the above cases, the prices paid by the U.S. companies did not reflect arm's length pricing

-- the standard required under U.S. law.

In determining an arm's length transfer price, the IRS must consider such factors as rebates, warranties, advertising expenses, and fluctuations in foreign currencies. For instance, in many automobile cases, the IRS focused on the use of rebates. Generally, rebates are utilized by automobile manufacturers to help dealers sell new cars. For instance, the manufacturer will give a dealer $500 for the sale of a particular model. The dealer could sell this new automobile at cost, show the customer the cost invoice as a selling "gimmick" and still end up with a gross profit of $500.

According to the IRS, the use of rebates by foreign-owned manufacturers often is not reflected in the transfer price paid by its U.S. subsidiaries. Distributors of durable goods operating at arm's length would not purchase automobiles from a manufacturer at a price that does not take into consideration rebates. The IRS contends that, since the manufacturer is directly or primarily affected by the sale of the year-end new cars, the rebates are directly or primarily the expense of the manufacturer and should be considered as such in determining the transfer price. The question being asked by IRS agents is "why should the U.S. government be subsidizing the promotional activities of foreign car manufacturers?"

Other methods frequently used by U.S. subsidiaries to reduce their tax liability involve the allocation of advertising expenses and warranty costs. Here, expenses for advertising, other promotional activities, and warranty costs are borne by the related distributor with no corresponding price concession from the foreign parent. In an arm's length transaction between unrelated parties, a distributor would not bear the burden of added associated expenses such as advertising and warranty costs, without securing a corresponding price reduction in the costs of goods sold.

According to the IRS, advertising and warranty costs are often not properly reflected in the transfer price. In one case, the advertising expenses exceeded fifty percent of the company's gross profit, whereas the industry, in general, spent between three and five percent of gross profits on advertising.

The Subcommittee obtained information from the IRS concerning the total amount of section 482 issues currently under review by IRS in Appeals and in the courts. As of December 31, 1989, there were 223 transfer pricing cases in Appeals totalling $6.2 billion in proposed adjustments. These figures were obtained only from IRS "large case" reports; consequently, the actual tax adjustments may be much larger. Further, as of February 1990, there were 71 cases in litigation with a total of $6.7 billion in proposed section 482 adjustments. Therefore, there are cases in Appeals and litigation which involve proposed adjustments approximating $13 billion.

III. FREIGHT, INSURANCE, INTEREST, AND OTHER FEES OR CHARGES:

There are other mechanisms, in addition to transfer pricing, which allow foreign multinationals to shift income out of the U.S. Through the use of fees, multinationals can charge their U.S. subsidiaries exorbitant insurance, interest, and freight costs. These fees are routinely dictated to the U.S. companies by foreign multinationals and are seldom the product of negotiation.

One example of how foreign parent companies can "skim" profits is by overcharging for ocean freight. These inflated fees inappropriately increase the price the U.S. subsidiary pays for the products it imports. In some instances, the Subcommittee found that foreign manufacturers shipped to their U.S. subsidiaries merchandise identical to that shipped to unrelated distributors. The manufacturer, or its shipping subsidiary, would charge its U.S. distributor more in freight charges than the amount billed to the unrelated company for identical merchandise carried on the same vessel, arriving on the same day to the same port.

In one case, the IRS witnessed hundreds of trucks being unloaded at the dock for both a controlled and an unrelated domestic distributor. The trucks were identical except that the vehicles being delivered to the domestic distributor had some cosmetic differences. Through the use of Customs import invoices, the IRS learned that the foreign-owned subsidiary was being charged almost $200 more per truck for shipping than the amount charged to the domestic company.

The Subcommittee staff also has evidence that companies have used interest charges to "skim" profits. One foreign multinational charged its U.S. subsidiary $15 interest per vehicle on the invoice amount although interest payments were not required under the distribution agreement. Industry practice is to allow distributors 10 days to pay the invoice without interest.

The Subcommittee also has evidence that foreign parents have charged their U.S. subsidiaries for insurance that was unnecessary. In one case, the U.S. subsidiary's inventory was already covered under a separate policy, but the foreign parent double billed it for the same insurance.

Other examples of improper expenses include a company that set up a reserve for Commerce Department anti-dumping penalties and took an immediate $8 million deduction against costs-of-goods sold.

Finally, IRS reports that some of the companies reviewed have gone so far as to de-centralize their U.S. operations in an effort to minimize detection by the IRS large case audit program, while others use multiple transactions to establish elaborate paper trails in an attempt to justify their transfer pricing.

IV. IRS INTERNATIONAL ENFORCEMENT PROGRAM:

The IRS employees interviewed during the investigation are very dedicated and competent professionals. A major problem is the IRS's level of staffing in relation to the growth in the international area. The number of foreign-owned corporate income tax returns filed increased from twenty thousand in 1980 to forty-five thousand in 1987. International staffing increased from approximately two hundred international examiners in 1980 to almost five hundred positions in 1990. Although staffing has increased, the IRS does not currently have a system in place to determine the optimal staffing needs or measure the effectiveness of its compliance programs. The IRS could not provide the Subcommittee with information concerning the marginal rate of return on section 482 examinations.

As one IRS agent put it, "yes, the agency is outgunned." In one case, the examination team tried to get an IRS economist assigned to the project for eight months. Once assigned, the economist advised the international examiner that for budgetary reasons he would not be going to the field to personally work the case, but asked the examiner to give him a call if the agent "found something". The IRS approached the examination in this manner, while the company was represented by a prominent accounting firm and an experienced tax attorney.

According to the IRS, attorneys from major law firms brag to international examiners that IRS audits of foreign-owned subsidiaries "mean millions in fees to the firms". At the same time, experienced IRS agents and attorneys are leaving the agency daily for better paying jobs.

State and county governments pay their senior attorneys significantly more than the Federal government. For instance, Orange County, California, pays its senior attorneys almost $20,000 more a year than the IRS pays its most senior and "seasoned" attorneys. Outside the government, these same attorneys could triple their salaries overnight. They put it bluntly: "how can we stay in government and, more importantly, why?"

The successful development, resolution, and litigation of section 482 cases requires a complex and thorough economic analysis of the involved transactions. The IRS has 40 economists; a major accounting firm employs at least as many for its clients. Economic experts must be highly credible and able to articulate their conclusions. Although IRS economists are essential to the development of section 482 cases, a number of obstacles face these economists that often necessitate the hiring of outside experts. These obstacles include the following:

Many IRS economists do not have Ph.D.s, have not extensively published in their field, and have not testified in court. IRS economists are often perceived by the courts to be biased in favor of the IRS. Outside economists usually have prior litigation experience, are widely published, and are generally considered to be leaders in their field. They charge between $150 and $450 a hour. The IRS economists are paid approximately $44,000 a year. According to the IRS, it is often difficult to retain experienced economists at this salary. Despite this fact, the IRS downgraded the salaries of their economists.

The IRS economists do not have many of the resources that exist for outside experts. For example, outside economists have access to information databases which the IRS does not provide to its economists. IRS economists must develop their economic analyses case-by-case with time consuming research in libraries. The IRS has also reduced its international training and eliminated its participation in international section 482 conferences.

Investigation of the IRS's international enforcement program revealed a number of serious deficiencies. The IRS is suffering from a lack of resources and is experiencing severe budgetary problems which have drastically affected the number and quality of examinations of foreign-owned companies and the collection of tax revenues. For instance, the IRS cannot assign twelve large transfer pricing cases in the Western region to IRS economists because the eight economists in the region are overworked. One IRS district counsel office was allocated twenty-three attorney staff positions but has only eighteen on board, almost all with less than four years experience. According to the IRS, grocery check-out clerks in Southern California can make more money than a first-year IRS attorney.

The IRS has prematurely closed examinations because of internal pressures to dispose of cases early. Some transfer pricing audits are limited to single product lines because the IRS does not have the time or resources to do comprehensive examinations. In some cases, transfer pricing issues are avoided because they are too unmanageable and would not produce significant revenues.

The IRS must go through a cumbersome administrative procurement process to hire outside experts. While corporations can instantly hire experts, the IRS must go through a competitive bidding process. In one case, it took the IRS several months to hire an outside economist. In another case, an American university encouraged a professor to avoid working with the IRS for fear of losing corporate contributions.

Further, under existing procedures, IRS examiners are required to use certain pricing methodologies in a prescribed order. Some IRS international examiners objected to the rigidness of the procedures and believe the process needs more flexibility.

The IRS does not effectively coordinate the handling of international tax issues. Each case involving section 482 is handled separately. International examiners do not communicate with each other regarding the development of common issues or the sharing of industry data. Many of the transfer pricing schemes are similar in nature, but the IRS must "re-invent the wheel" each time an examination is conducted.

In essence, the IRS's international enforcement program suffers from the lack of resources and coordination. It is hamstrung by bureaucratic "red tape", whether it is the procurement of experts or being "handcuffed" by the regulations that prioritize pricing methodologies. The IRS's internal problems are further exacerbated by the difficulties encountered with the taxpayers.

The corporate community has developed what the IRS agents term, "combat strategies". One such document obtained by the Subcommittee staff reveals that corporations are instructed to avoid retaining non-privileged documents that do not support, or that might contradict, tax positions taken or that could serve as a "road map" for audit if obtained by the IRS. The document goes on to instruct companies on when to refuse to extend the statute of limitations and, how to respond, or avoid responding, to IRS requests for information.

The companies reviewed are represented by the best legal talent the U.S. has to offer. These companies often hire outside experts just to keep them away from the IRS. The companies talk to one another keeping each apprised of IRS audit techniques and issues raised. According to the IRS, if one company begins to take advantage of a tax issue, the entire industry begins to do likewise.

Often times, the IRS agents conduct their examinations in the U.S. subsidiary's offices. According to the IRS, these companies often move the agents from one office to another disrupting their examinations. In one case, a company gave the IRS office space in the cafeteria and then refused to provide tax information claiming the agent's work was not secured. In another, the company placed the agents in a six-by-six foot guard house in the parking lot. An IRS agent indicated that the company suggested that one of its security guards disable the air conditioner in the IRS's office.

V. IRS PROBLEMS IN OBTAINING INFORMATION:

The Subcommittee staff found that it usually takes ten years to complete an automobile audit, four to six years for a motorcycle or electronics equipment case. In almost all of the cases reviewed, the IRS agents reported that the difficulties encountered in obtaining information from the taxpayers makes for a long, drawn-out process. Taxpayer delay is often the name of the game. In many instances, the attorneys representing these companies prolong the resolution of these tax disputes by "spoon feeding" the IRS information.

The IRS issues information document requests to the taxpayer for specific data needed to determine the propriety of the company's pricing. All companies retain this information because it is instrumental to their current operations and future planning. The companies, however, frequently fail to provide requested data, forcing the IRS to resort to the use of an administrative summons and formal document requests under section 982.

In some of the cases reviewed, the IRS was forced to resort to treaty requests, whereby the IRS asked the foreign country to "knock on the door" of its resident corporate parent and obtain the information. In a couple of cases, the IRS was compelled to seek judicial enforcement of an administrative summons. Under U.S. v. Toyota Motor Corp., 561 F. Supp. 354 (C.D.Cal. 1983), the court ruled that the IRS can obtain documentation from a foreign parent where the records sought are related to the business being conducted in the U.S. through the subsidiary, such as records relating to intercompany pricing.

According to the IRS, it has closed examinations without proposing any adjustments because the company was uncooperative and the IRS was unable to get the necessary information to work the transfer pricing issue. In one case, the company refused to provide foreign-based information claiming "we aren't required to keep such records by law in our home country". In another case, the company took a different approach, providing the IRS with 40 boxes of documentation without an index. One company provided the IRS with all facsimiles generated throughout the year, except those sent around the time the foreign parent raised its prices. According to the IRS, those documents were conveniently missing.

According to the IRS, there are other Federal agencies that receive information from foreign multinationals which would be useful in conducting transfer pricing audits. For instance, the Commerce Department collects foreign-based data during its anti-dumping enforcement efforts. Commerce questionnaires soliciting cost and pricing information are received from foreign companies but are not disclosed to other Federal agencies, including the IRS. Similarly, the Customs Service conducts importation and duty investigations but does not routinely share the information collected with the IRS. Federal disclosure laws are often cited as reasons for agencies refusing to exchange data.

VI. AVOIDANCE OF CUSTOMS DUTIES:

During the course of the Subcommittee's investigation, we became aware of several duty-avoidance schemes engaged in by foreign subsidiaries operating in the U.S. In one of these cases, the overstatement of freight and insurance costs on imported products were used to avoid both tax and duty. Since the IRS and Customs do not coordinate their investigative findings very well, it is questionable whether these companies were assessed additional amounts for both.

The first scheme involves freight and insurance costs of the importer which are nondutiable charges. The overstatement of nondutiable charges fraudulently decreases the dutiable value of imported products and, therefore, the amount of duty paid. Since freight and insurance charges are also deductible business expenses, they decrease the amount of taxes paid.

Customs has found through its "Operation RAP" (Rebate and Adjustment Program) that numerous international freight and insurance companies are charging for freight and insurance "on paper" to the importing subsidiaries, and then paying "kickbacks" to the firms in the form of cash or money orders. For example, invoices filed with Customs by the subsidiary show freight and insurance charges at the higher rate without reflecting the kickbacks. The subsidiary then deducts the larger figure from the price when calculating the amount of duty owned.

Customs reports that the catalyst for Operation RAP was a Customs investigation of a Japanese automobile manufacturer. In this case, the freight company and the U.S. distributor were all subsidiaries of the foreign company. In the end, the company agreed to pay Customs over $6 million in additional duties and penalties. Since then, Customs has collected another $3 million in additional duties and penalties from foreign-owned subsidiaries of multinationals for overstating freight and insurance charges and continues to investigate a substantial number of foreign-owned subsidiaries suspected of engaging in this scheme.

In another case, Customs has found that a foreign-owned automobile manufacturer may have taken advantage of a number of complex trade laws to avoid paying any duty on automobiles sold in the U.S. In this case, which was uncovered as part of "Operation Tin Lizzie", the finished automobiles were imported from Canada. At that point, the manufacturer claimed that the automobiles were duty free under the recent Canada-Free-Trade Agreement because they have more than 50 percent "North American" content. However, upon closer examination, it appears that only a handful of the parts in the automobile were actually North American.

One part, the engine, which accounts for a substantial portion of the value that the manufacturer claimed to be North American, was assembled in the U.S. from foreign parts by a subsidiary of the foreign manufacturer. Because the engine-assembly subsidiary was importing only parts and then exporting a finished engine to Canada, U.S. trade laws allowed the manufacturer to claim that the engine was made in the U.S. However, Customs has two problems with this scheme.

First, the manufacturer is claiming a refund of the duties paid on the foreign engine parts when the furnished engines are exported to Canada. In Customs' opinion, this claim is illegal because the manufacturer is later claiming the engines as U.S.-made when they are re-imported into the U.S. as part of a finished automobile. More importantly, Customs believes that the value claimed by the manufacturer for the engine when calculating the percentage of North American content in the finished automobile is overstated and that the automobiles do not qualify for duty-free status. The price that the Canadian subsidiary of the foreign manufacturer paid to the U.S. engine-assembly subsidiary was inflated by just enough to bring the percentage of North American content up to the point needed to qualify the entire finished automobile for duty-free status upon entry into the U.S.

Mr. Chairman, this concludes our statement. If you or any of the other Members have questions, we would be happy to try to answer them.

# # # # #

ELECTRONIC DISTRIBUTORS (18)
(Dollars in Billions)

OVERALL AGGREGATE NUMBERS:

NUMBER OF RETURNS REVIEWED	106
GROSS RECEIPTS	$116.4
COST-OF-GOODS SOLD	90.5
GROSS PROFITS	25.9
TOTAL INCOME	27.5
TOTAL DEDUCTIONS	26.1
TAXABLE INCOME	1.6
TOTAL TAX	.6
PROPOSED ADJUSTMENTS	.2

TAX YEAR 1987:

NUMBER OF RETURNS REVIEWED	10
TOTAL ASSETS	$ 12.0
GROSS RECEIPTS	38.1
COST-OF-GOODS SOLD	34.2
GROSS PROFITS	3.9
TOTAL INCOME	4.6
TOTAL DEDUCTIONS	3.8
TAXABLE INCOME	.7
TOTAL TAX	.4
PROPOSED ADJUSTMENTS	0

TAX YEAR 1986:

NUMBER OF RETURNS REVIEWED	13
TOTAL ASSETS	$ 17.7
GROSS RECEIPTS	44.8
COST-OF-GOODS SOLD	39.9
GROSS PROFITS	4.9
TOTAL INCOME	5.6
TOTAL DEDUCTIONS	4.9
TAXABLE INCOME	1.2
TOTAL TAX	.5
PROPOSED ADJUSTMENTS	0

TAX YEAR 1985:

NUMBER OF RETURNS REVIEWED	14
TOTAL ASSETS	$ 12.6
GROSS RECEIPTS	37.8
COST-OF-GOODS SOLD	31.3
GROSS PROFITS	5.5
TOTAL INCOME	6.1
TOTAL DEDUCTIONS	3.9
TAXABLE INCOME	2.2
TOTAL TAX	1.0
PROPOSED ADJUSTMENTS	.1

AUTOMOBILE/MOTORCYCLE DISTRIBUTORS (18)
(Dollars in Billions)

OVERALL AGGREGATE NUMBERS:

NUMBER OF RETURNS REVIEWED	116
GROSS RECEIPTS	$212.8
COST-OF-GOODS SOLD	199.9
GROSS PROFITS	28.5
TOTAL INCOME	32.0
TOTAL DEDUCTIONS	22.6
TAXABLE INCOME	9.2
TOTAL TAX	4.4
PROPOSED ADJUSTMENTS	2.5

TAX YEAR 1987:

NUMBER OF RETURNS REVIEWED	14
TOTAL ASSETS	$ 16.7
GROSS RECEIPTS	20.4
COST-OF-GOODS SOLD	16.1
GROSS PROFITS	4.2
TOTAL INCOME	4.5
TOTAL DEDUCTIONS	4.6
TAXABLE INCOME	.2
TOTAL TAX	.04
PROPOSED ADJUSTMENTS	0

TAX YEAR 1986:

NUMBER OF RETURNS REVIEWED	15
TOTAL ASSETS	$ 10.5
GROSS RECEIPTS	17.2
COST-OF-GOODS SOLD	13.7
GROSS PROFITS	3.5
TOTAL INCOME	3.7
TOTAL DEDUCTIONS	3.6
TAXABLE INCOME	(.02)
TOTAL TAX	.07
PROPOSED ADJUSTMENTS	.005
AMOUNT SUSTAINED	0

TAX YEAR 1985:

NUMBER OF RETURNS REVIEWED	17
TOTAL ASSETS	$ 9.6
GROSS RECEIPTS	16.4
COST-OF-GOODS SOLD	12.7
GROSS PROFITS	3.6
TOTAL INCOME	3.8
TOTAL DEDUCTIONS	3.6
TAXABLE INCOME	.03
TOTAL TAX	.08
PROPOSED ADJUSTMENTS	.004

Chairman Pickle. I thank you, Mr. Heck. Do any other members of the staff have any additional statements you want to make at the time?

Do any of the members have questions of the staff at this particular point. I thank you very much. We will have questions, but we are going to come back later. We had earlier voted that we were going into closed session.

Let me say again that we will be going into closed session as voted and we will probably stay in closed session for approximately an hour and a half. We hope we can finish by that time. Then we will resume at approximately 12:30 or 1 and then be in open hearing. So the Chair will now ask the members in the audience who are guests here if they will please leave the room and we will ask you will you please leave it quickly.

[Whereupon, at 10:55 a.m., the subcommittee proceeded into closed session.]

[Subsequently, at 1:45 p.m., the subcommittee reconvened.]

Chairman Pickle. We have a full schedule already.

We will proceed as quickly as we can. We are anxious to get all the facts that we can on the record.

Our first panel this afternoon will be the Honorable Fred T. Goldberg, the Commissioner of Internal Revenue. He is going to be accompanied by Steve Lainoff, who is the Associate Chief Counsel for the International Division.

Will you identify the other individual with you and proceed as you wish? We have your statement, I believe, and we would like for you to stay with it if you care to. The entire statement will be part of the record. We are pleased to have you this morning and thank you for your cooperation.

STATEMENT OF HON. FRED T. GOLDBERG, JR., COMMISSIONER OF INTERNAL REVENUE, ACCOMPANIED BY DON BERGHERM, ASSISTANT COMMISSIONER, INTERNATIONAL, AND STEVEN R. LAINOFF, ASSOCIATE CHIEF COUNSEL, INTERNATIONAL, INTERNAL REVENUE SERVICE

Mr. Goldberg. Thank you, Mr. Chairman.

I am pleased to appear before you today to discuss our current efforts and initiatives to apply the code section 482 rules on foreign controlled companies doing business in the United States. During my testimony I will refer to these businesses as FCC's.

With me are Don Bergherm, the Assistant Commissioner (International). Steve Lainoff is the Associate Chief Counsel (International).

Before beginning my testimony I would like to note that the subcommittee and staff have heard and will hear again today from a number of IRS field examiners, economists and attorneys. These individuals and their colleagues live in the real world of tax administration. They are capable and dedicated professionals who I believe are doing a tough job under extremely difficult circumstances. I would like to express the agency's respect and gratitude for a job well done. I would also like to thank the subcommittee and staff for taking the time to listen to their views.

Code section 482 allows the IRS to allocate income and expenses among related taxpayers in order to prevent tax evasion and to ensure that the income of these taxpayers is clearly reflected. This authority has applicability to a wide variety of transactions, but is particularly significant in the international context. The reason, of course, is quite obvious: multinational companies doing business in the United States should pay their fair share to the U.S. Government. Our job is to make certain that they are not improperly "shifting" income to foreign jurisdictions, and thereby understating their U.S. income tax liability.

Based on our continuing review of IRS enforcement efforts in this area, we have a number of concerns and tentative conclusions that I would like to share with you.

First, the aggregate data, and our own examination activities, suggest that foreign controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities. While we cannot yet estimate the magnitude of the problem, we believe that the shortfall is substantial.

Chairman PICKLE. We have estimates anywhere from $13 billion up to $40 or $50 billion. Could it be in that range possibly?

Mr. GOLDBERG. I think those statements may be on the high side, but I think an estimate in the billions of dollars would be appropriate.

Second, it would be a mistake to assume or conclude that transfer pricing problems arise only with respect to FCC's. The issue is also prevalent among U.S. controlled companies (USCC's) and their overseas operations. While business customs and access to information pose unique enforcement challenges in the FCC context, the underlying issue of transfer pricing is the same across the board.

Third, transfer pricing cases are inherently factual and subjective in nature. They require a great deal of cost, pricing and market data regarding the taxpayer and its competitors—information that taxpayers may be unwilling or unable to provide. These cases also call for expertise in commercial matters that have little to do with the tax law. As a result, they are extremely difficult, time consuming and costly to develop.

Fourth, the plain fact is that the IRS and taxpayers are not evenly matched in the transfer pricing arena. FCC's and USCC's devote far greater resources to the effort and have a monopoly on information that the IRS must have—but all too often cannot obtain.

Fifth, the IRS resources picture in this area is mixed. On the one hand, we have expanded our international enforcement efforts during the past 10 years—particularly with respect to cases involving FCC's. Indeed, we have continued this growth during the past 2 years despite the Service-wide hiring freeze, at the expense of other examination programs. On the other hand, our growth has not kept pace with the increased workload; as the direct result of recent budgetary shortfalls, we have failed to provide those working in the international area with all of the tools and training they need to do the job properly; and we have suffered high attrition among our most experienced professionals. I should also point out that the emphasis on IRS programs that generate short-term, "quick hit" revenues has caused extensive growth in these areas—

which tend to affect middle income individuals and small business taxpayers—relative to activities with a greater long-term payback—such as the transfer pricing area.

Sixth, IRS efforts in the transfer pricing area are of relatively recent vintage, particularly as they relate to FCC's. Accordingly, in light of the time it takes to develop specific cases, it is not yet possible to assess the impact of these efforts or the likely magnitude of any compliance problems. It is also clear that we can and should continue to improve the quality and productivity of our efforts in this area. In particular, the IRS needs to keep developing our inhouse expertise, make more and better use of outside experts, refine our case development strategies, and look for creative alternatives to the trench warfare techniques that the IRS and taxpayers now use in this area.

Seventh, there are a number of specific steps that Congress could take to improve taxpayer compliance and IRS activities in this area. Most notably:

Make the long-term investment necessary to improve and expand IRS transfer pricing enforcement efforts. The President's 1991 budget represents an important first step down this road. Mr. Chairman, I would like to thank you and your colleagues for your support in this regard.

Second, permit sole source procurement of outside experts to support IRS examination and litigation efforts. This may not sound like much, but it is probably the most important single step that Congress could take in helping us to improve our large case program and enforce the law against FCC's.

Enact those portions of H.R. 4308 that would make code section 6038A applicable to all open tax years and expand the scope of that section to cover reporting by foreign corporations with U.S. branches. The plain fact is that our ability to develop transfer pricing cases involving FCC's requires ready access to information that has been well beyond our reach.

Enact the administration's locality-based pay proposals. Private sector professionals handling transfer pricing cases earn many times what our employees make, particularly in high cost of living areas. We will never be competitive, but we must do better.

Finally, as I have stated, FCC's and USCC's raise significant compliance issues in the transfer pricing arena—we believe that the U.S. Government is being short-changed billions of dollars annually. Unfortunately, there are no quick fixes or easy and dramatic solutions. The IRS has been doing a good job of administering section 482 under circumstances that exist today; if Congress and the administration take the steps I have just summarized, we can—and we will—do a much better job in the years ahead.

Chairman PICKLE. Before you proceed, with respect to these recommendations, have you officially, the IRS, recommended them to Treasury, has Treasury said that it ought to be done, have we heard from them, have you established positions on these recommendations?

Mr. GOLDBERG. Yes, sir, each recommendation is being made with the full concurrence of the Department of Treasury and the OMB.

Chairman PICKLE. All right.

Mr. GOLDBERG. The past decade has seen a dramatic increase in foreign investment in the United States. Many foreign companies have established a significant U.S. presence, and have set up U.S. subsidiaries or branches to carry on their business operations.

I would like to refer you to the charts to your left. Chart 1, which is attached to my statement, illustrates this trend by showing the growth of assets and worldwide receipts of U.S.- and foreign-controlled corporations during the period 1979–87—the last year for which we have data. The assets of FCC's grew by 368 percent, from $205 billion to $959 billion, while the assets of all other U.S. corporations grew by only 102 percent. Likewise, the total receipts of FCC's grew by 183 percent, from $242 to $685 billion, while the total receipts of all other U.S. corporations grew by only 52 percent.

To place the 1987 numbers in perspective, $959 billion equals about 6 percent of the total assets of all U.S. corporations, up from 3 percent in 1979; $685 billion equals about 7 percent of the total receipts of all U.S. corporations, up from 4 percent in 1979. This growth manifests the increasing importance of this area of the tax law.

Although the growth of foreign investment in the United States is often discussed in the transfer pricing context, the converse is equally true and well worth noting. U.S.-based corporations have a significant and growing presence overseas. Many of these corporations report a large part of their sales, or profits, outside of the United States. In fact, for those companies claiming foreign tax credits, studies show that half of their worldwide taxable income is derived from foreign sources. See chart 2, which is attached to my written statement. .

A great deal of attention has been paid of late to IRS statistics of income data regarding taxes paid by FCC's relative to all other U.S. corporations. This data is reflected in charts 3 through 7, all of which are attached to my written statement. Chart 3 shows the rate of return on assets for all FCC's and all other U.S. corporations during the period 1981–87. Chart 4 shows total net income as a percentage of total gross receipts for FCC's and all other U.S. corporations during the period 1981 to 1987. U.S.-controlled corporations generated a return on their assets at a range of 1½ to 2 percent during that 7-year period. Foreign corporations doing business in the United States generated returns on their assets of around 0.3 to 0.5 percent or more than a percentage point less during that same period, and in 1986 had negative return.

In other words, foreign controlled companies doing business in the United States in terms of their taxable income consistently over a 7-year period showed significantly less taxable income relative to their assets than did U.S. companies doing business in the United States.

The next chart, the chart on the right shows—chart 4 shows total net income as a percentage of total gross receipts for foreign controlled corporations and all other U.S. corporations during the same period.

Again, what you see is that U.S. controlled companies consistently reported net income as a percentage of gross receipts at between 2.5 and 3 percent during that period while again foreign controlled corporations showed net income as a percentage of total receipts in the range of about one-half a percent. So again, what you see is the foreign controlled corporations doing business in the United States reported taxable income as a percentage of their gross receipts that was less than half the taxable income being reported by U.S. companies doing business in the United States.

Chart 5—I have pointed out now the growth in foreign controlled company activity in the United States, and what chart 5 shows is that that growth and receipts of foreign controlled corporations has been dramatic with respect to all four of the countries that you have inquired about—these are foreign controlled domestic corporations whose parent controlling company is located either in Japan, United Kingdom, West Germany, or Canada.

Chart 6 shows net income as a percentage of receipts for all U.S. companies. In other words, U.S. companies' income as a percentage of receipts was running between 2-1/2 and 3 percent. What those other four lines do is break down income as a percentage of receipts by foreign controlled companies in each of the four jurisdictions you have expressed interest in.

Chart 7 tries to approach it—we have talked about it in the aggregate, now on a country-by-country basis. Chart 7 tries to get at the same question by looking at net income as a percentage of total receipts for differing business activities. Chart 7 shows that for example, in the manufacturing area, U.S. companies showed 4.3 percent income as a percentage of total receipts on a cumulative basis, while foreign controlled showed net income of 1.7 percent.

You see similar relationships in the wholesale/retail trade area and in the finance and insurance area. U.S. controlled companies showed cumulative income as a percentage of total receipts at 5.7 percent while the foreign controlled companies in those particular industries showed a cumulative deficit and income of 0.3 percent.

Mr. McGRATH. Would the gentleman yield?

On the finance and insurance, could you tell me concerning the those foreign controlled domestic companies, what the growth of that industry has been during the period we are referring to?

Mr. GOLDBERG. We would be happy to get you that data, Mr. McGrath. We have the growth by industry. It is not provided in any of the charts. We can get that.

Mr. McGRATH. It would seem to me that there has been a large increase in the growth of that particular segment——

Mr. GOLDBERG. It clearly has been dramatic.

Mr. McGRATH. As opposed to the reflection of what their net income was.

Thank you.

Mr. GOLDBERG. We will have that to you shortly.

[The following was subsequently received:]

Growth of Finance and Insurance, 1983 - 1987

Foreign Controlled Domestic Corporations

Total Receipts:

1983	$31,870,411,000
1987	$55,157,015,000
Percentage Increase	73.1%

Total Assets:

1983	$169,435,636,000
1987	$334,388,480,000
Percentage Increase	97.4%

Other Corporations

Total Receipts:

1983	$804,250,094,000
1987	$1,420,624,972,000
Percentage Increase	76.6%

Total Assets:

1983	$5,134,980,052,000
1987	$8,125,624,908,000
Percentage Increase	58.2%

Mr. Goldberg. You look at this data and it is clear that this data demonstrates that foreign controlled corporations may be substantially understating their U.S. income tax liability. This conclusion applies with equal force to FCC's controlled by Canadian, Japanese, British, and West German companies, and to each of the primary types of businesses pursued by FCC's.

The data is certainly cause for concern, and those at the IRS who have been pursuing FCC transfer pricing cases since the early 1980s should be congratulated for their foresight and their activities to date. I should note that the transfer pricing adjustments that have been made or are pending against FCC's suggest that IRS concerns are well-founded.

At the same time, it is absolutely essential to keep two points in mind:

First, the aggregate data does not prove widespread noncompliance by FCC's. It might be argued that the variances we have noted could be explained by a variety of factors that have little to do with improper transfer pricing. Most notably:

The data is not adequately refined to permit direct company-by-company, business-by-business, and product-by-product comparisons that would conclusively demonstrate transfer pricing abuses.

Startup companies tend to be less profitable than their established counterparts—a disproportionate number of FCC's may fall into the start-up category, accounting for a portion of the variance. In this regard, I would like to call the subcommittee's attention to chart 8, which is the chart on the right.

That shows that during the 5-year period approximately that 55 percent of the U.S. controlled companies showed profits while only 40 percent of the foreign controlled companies were showing profits. This could be attributable to the fact that there are a disproportionate number of startup companies, it could also be explained by other factors.

I should also note that legitimate differences in capital structure could also account for a portion of the variance—for example, if FCC's are more heavily leveraged than their USCC counterparts.

Chairman PICKLE. Commissioner, I think that is interesting, these two categories. The hearing today is based on interviews and reviews of 36 companies. None of them, I believe, are startup companies. This is an interesting fact, but it just shows that in earlier years they got heavy deductions and depreciations, but the companies we have been looking at were not early startup companies. Does this go to the heart of this hearing?

Mr. GOLDBERG. Mr. Chairman, I think part of our job is to deal forthrightly with the subcommittee and point out that the aggregate data is very striking, but you can't jump too fast, and I think it is fair that we acknowledge there may be other causes. Those factors may be present, but nonetheless there are serious transfer pricing issues, and I think we ought to acknowledge that there are other sides.

Chairman PICKLE. We certainly want to be fair about it, but this is the type of argument you would normally hear from lobbyists more than from the Treasury.

Mr. GOLDBERG. I heard the snickers from the back, so I assume you are correct, Mr. Chairman. I think that we need to be very careful in rushing to judgment. Our judgment is that the data we have shown you is serious cause for concern, may well demonstrate significant noncompliance, but there are limitations to that aggregate data and we have to make our cases taxpayer by taxpayer.

I think the other point is that the IRS has encountered significant transfer pricing issues involving U.S. based multinationals. Our examination efforts to date make clear that certain of these taxpayers are also understating their tax liability and should be subject to adjustments under code section 482. We do not have aggregate USCC data. However, there are indications that USCC's may engage in the same type of income shifting as FCC's.

In this regard, I would like to call the subcommittee's attention to an article entitled "Transfer Pricing Issues" by Lowell Dworin, Director, Office of Tax Analysis, U.S. Department of Treasury.

Based on the foregoing, we believe that the IRS must continue to pursue a balanced enforcement strategy that deals with FCC's and USCC's in an evenhanded manner. At the same time, we must recognize and we must deal with the unique administrative difficulties that arise in dealing with FCC's as compared to their USCC counterparts.

I would like to turn to page 20 of my testimony. Pages 10 through 20 described how we handle cases and the types of cases encountered. As you heard this morning, they described it in more eloquent and graphic terms than I could hope to do.

I think the IRS should be congratulated for the way it has responded during the past decade to the challenges posed by the explosive growth of multinational business activity and the proliferation of international tax issues—most notably, in the transfer pricing area. Without question, we should do more, and we should do better—but I am confident that we are heading down the right road.

The IRS has made significant organizational changes and has committed additional resources to addressing international tax compliance issues. In 1986, the Office of Assistant Commissioner—International—was established to better focus and coordinate our efforts in dealing with foreign Governments and the full spectrum of taxpayers involved in international transactions.

At the same time, a counterpart Office of Associate Chief Counsel—International—was established to achieve parallel benefits within the office of chief counsel regarding international tax technical and controversy matters. While it is too early to assess the long-term impact of these organizational changes, I believe they have had a positive impact to date and will pay substantial dividends in the years ahead.

The IRS has significantly increased staffing in all functions that deal with international issues. As reflected in attached chart 9, the number of international examiners (IE's) has increased from 150 in 1977 to 490 this year. In this regard, you should note that the number of IE's has increased over the last 2 years despite the Service-wide hiring freeze. This has been accomplished by reducing revenue agent activity in other areas.

We have been robbing Peter to pay Paul. Given the importance of the international area, we have shifted resources out of domestic examinations in this direction.

As we have stated on numerous occasions, transfer pricing issues require substantial expertise in nontax areas—most notably, economic analysis. With this in mind, our inhouse staff of economists working international tax matters has more than doubled during the past 7 years, from 14 to 35 today.

Approximately 500–600 FCC's are under audit during any given year. In most cases, the examination will involve multiple tax years. As reflected in attached chart 10, we are currently auditing approximately 520 FCC's, with approximately 1,130 tax returns under consideration. For tax year 1987 returns, we currently plan to audit approximately 600 FCC's.

From chart 11, you will see that 600 companies represent only 1.3 percent of all of the foreign controlled company returns. At the same time, however, those 600 returns cover foreign controlled companies reporting more than 50 percent of total assets and gross receipts for that year.

During fiscal year 1989 our IE's proposed $500 million in transfer pricing adjustments involving FCC's, and approximately $4 billion for USCC's—almost $3 billion of that $4 billion was recommended in the examination of two taxpayers, and both are contesting these adjustments in Tax Court. Through April of fiscal year 1990, transfer pricing adjustments recommended by IE's are approximately $350 million for FCC's and $225 million for USCC's.

As is evident from the foregoing, the IRS has expanded its resource commitments to the international area, and is developing significant proposed tax adjustments. At the same time, however, we believe that our efforts have not kept pace with the growth in workload and the potential magnitude of noncompliance in this area. To cite but two examples, our inhouse economists can handle less than one-third of the transfer pricing cases our existing group of IE's is developing. Also, while the number of IE's increased substantially between 1977 and 1989, both the number and complexity of FCC and USCC returns has also increased.

Additional staffing in the international area is appropriate, but it is only a small part of the overall solution. We must do more to retain our professionals and provide them with the training and tools to do their job properly.

During the past 3 years, we have lost more than 80 of our most experienced international examiners to retirement or—more often—jobs in the private sector. This is more than 15 percent of the total IE workforce. As a result, the average years of experience of our IE's has declined significantly. In high cost of living areas—most notably, the northeast and southern California—we have difficulty hiring and retaining expert personnel.

For example, in Manhattan we currently have 5 economists and 15 IE vacancies that we have been unable to fill. This is particularly troublesome because many of our most significant international examinations occur in these areas.

As we have testified on many occasions during the past year, the IRS has been unable to invest in the training and tools necessary for the long-term health of our tax system. This pattern has affected all aspects of our enforcement program—including the international area. The adverse impact of these reductions is magnified in light of the increased number of IE's and the decline in their experience levels.

While the IRS requires outside experts for many reasons in large case examinations, the need is most compelling in the transfer pricing arena. Indeed, Mr. Chairman, they are absolutely essential. Let me be perfectly clear on this point: without timely access to top flight experts during the development, settlement and if necessary the litigation of transfer pricing cases, we simply cannot and will not adequately protect the Government's interest.

Unfortunately, our ability to obtain outside experts is limited by funding concerns and needlessly cumbersome procurement rules. Indeed, current procedures for obtaining the support of outside experts is so convoluted and unworkable that we often fail to spend all of the funds we have budgeted for that purpose.

Unlike taxpayers in the private sector, we cannot just pick up the phone and hire the people we need. Instead, detailed procedures, including competitive bidding, must often be followed. The very fact of an open procurement process can sometimes compromise our case development efforts.

It is clear that resource limitations, the inability to properly compensate our employees, and the procurement process all inhibit our efforts to adequately administer the tax laws in a wide variety of areas, including FCC transfer pricing cases. Nonetheless, it is equally clear that we can and should do better with what we have.

Among the many initiatives that we are pursuing, I would like to mention several that are particularly promising. First, we are revamping our training programs and developing specialists among our IE's, appeals officers and chief counsel attorneys who will focus on particular aspects of international taxation. These individuals will be available to assist in working significant cases throughout the country.

The era where one person could master much of the tax law has long since passed. We must centralize and focus certain of our enforcement efforts, and break down functional and geographic barriers within the IRS, to assure uniformity and quality case development.

Second, we are pursuing a strategic initiative focused specifically on the recruiting and retention of international examiners. This effort should be completed by the end of the year; implementation will be a top priority in the years ahead.

Third, we must look for creative alternatives to the current trench warfare method of developing and resolving transfer pricing cases. At one end of the spectrum, we continue to explore alternative dispute resolution techniques—for example, binding arbitration. At the other end of the spectrum, a potentially promising effort involves an advance determination procedure.

This avenue is similar in some respects to a private letter ruling. A taxpayer would submit specific information regarding its intercompany pricing structure and operations. The IRS would examine this data in light of the markets involved, and comparable activities performed by competitors.

We are currently negotiating advance-determination agreements with a number of specific taxpayers on a pilot basis, and are preparing a revenue procedure for general application.

Finally, we must be—and are—willing to ask for help from Congress in our efforts to better administer the law. With this in mind, I would like to turn to a number of legislative initiatives.

In the first place, there are no quick, easy and dramatic ways to improve compliance in the transfer pricing arena. What is required is a long-term investment in top flight administration of the tax laws. In particular:

One, the IRS budget. The administration's proposed fiscal year 1991 budget for the IRS is a critical first step to maintain and enhance the health of our tax system. It will permit an expansion of our enforcement efforts in a variety of areas, including transfer pricing by FCC's. Of equal importance, while it will not remedy the shortfalls of the past several years, it will begin to provide our employees with the training and tools they need to do their jobs properly.

Two, expert witnesses. The IRS must be able to obtain the support of outside experts in developing, settling and litigating transfer pricing cases. As currently structured, this process doesn't work. If Congress is serious about dealing with compliance issues involving large corporate taxpayers—including FCC's—you will permit us to retain outside experts on a sole source, fast track basis. By way of a road map, Congress could simply parallel existing laws governing the Environmental Protection Agency's ability to hire experts for purposes of administering the Super Fund provisions.

Information, as you have heard, is the key to developing transfer pricing cases. In 1989, Congress amended code section 6038A to make it easier for the IRS to obtain information with respect to foreign controlled taxpayers. These changes were effective only for tax years beginning after July 10, 1989, and did not generally apply to foreign corporations doing business through branch operations.

H.R. 4308 would extend the scope of section 6038A to cover all open tax years and clearly would cover reporting by foreign corporations doing business through branch operations in the United States. We believe these two provisions would help the Service do a better job in developing and closing existing cases, improve the quality of our work in the future, and help encourage up front voluntary compliance.

As you know, Mr. Chairman, the administration has proposed locality-based pay for Federal employees in high cost of living areas. Without question, this measure is critical to good government across the board. But that is more than an abstract proposition—it is day-to-day reality. Our 15 IE vacancies make the point. Our 15 percent attrition among experienced IE's makes the point. Our ability to enforce the law against foreign controlled corporations is clearly and directly affected by this issue. It is time we did something about it.

I want to thank you and your colleagues for your continued support and concern for the best in tax administration. Once again, you are focusing on a matter of great significance, are properly holding us accountable for our performance, and are seeking constructive improvements to enhance compliance with our tax laws.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of
Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
before the
Subcommittee on Oversight
House Ways and Means Committee

July 10, 1990

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss our current efforts and initiatives to apply the code section 482 rules on transfer pricing to foreign controlled companies doing business in the United States ("FCCs"). With me today are Don Bergherm, Assistant Commissioner (International), and Steve Lainoff, Associate Chief Counsel (International). We will be happy to answer any questions you might have at the conclusion of my testimony.

I. INTRODUCTION

Before beginning my own testimony, I would also like to note that the Subcommittee and staff have heard, and will hear again today, from a number of IRS field examiners, economists and attorneys. These individuals and their colleagues live in the real world of tax administration. They are capable and dedicated professionals doing a tough job under extremely difficult circumstances. I would like to take this opportunity to express the agency's respect and gratitude for a job well done, and would like to thank the Subcommittee and staff for taking the time to listen to their views.

Code section 482 allows the IRS to allocate income and expenses among related taxpayers in order to prevent tax evasion and to ensure that the income of these taxpayers is clearly reflected. This authority has applicability to a wide variety of transactions but is particularly significant in the international context. The reason, of course, is quite obvious: multinational companies doing business in the United States should pay their fair share to the United States government. Our job is to make certain that they are not improperly "shifting" income to foreign jurisdictions, and thereby understating their U.S. income tax liability.

Based on our continuing review of IRS enforcement efforts in this area, we have a number of concerns and tentative conclusions that I would like to share with you.

First, the aggregate data, and our own examination activities, suggest that foreign controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities. While we cannot yet estimate the magnitude of the problem, we believe that the shortfall is substantial.

Second, it would be a terrible mistake to assume or conclude that transfer pricing problems arise only with respect to FCCs. The issue is also prevalent among U.S. controlled companies (USCCs) and their overseas operations. While business customs and access to information pose unique enforcement challenges in the FCC context, the underlying issue of transfer pricing is the same across the board.

Third, transfer pricing cases are inherently factual and subjective in nature. They require a great deal of cost, pricing and market data regarding the taxpayer and its competitor(s)--information that taxpayers may be unwilling or unable to provide. These cases also call for expertise in commercial matters that have little to do with the tax law. As a result, they are extremely difficult, time consuming and costly to develop.

Fourth, the plain fact is that the IRS and taxpayers are not evenly matched in the transfer pricing arena. FCCs and USCCs devote far greater resources to the effort and have a monopoly on information that the IRS must have--but all too often cannot obtain.

Fifth, the IRS resources picture in this area is mixed. On the one hand, we have expanded our international enforcement efforts during the past ten years--particularly with respect to cases involving FCCs. Indeed, we have continued this growth during the past two years despite the service-wide hiring freeze, at the expense of other examination programs. On the other hand, our growth has not kept pace with the increased workload; as the direct result of recent budgetary shortfalls, we have failed to provide those working in the international area with all of the tools and training they need to do the job properly; and we have suffered high attrition among our most experienced professionals. I should also point out that the emphasis on IRS programs that generate short-term "quick hit" revenues has caused extensive growth in these areas--which tend to affect middle income individuals and small business taxpayers--relative to activities with a greater long-term pay back--such as the transfer pricing area.

Sixth, IRS efforts in the transfer pricing area are of relatively recent vintage, particularly as they relate to FCCs. Accordingly, in light of the time it takes to develop specific cases, it is not yet possible to assess the impact of these efforts or the likely magnitude of any compliance problems. It is also clear that we can and should continue to improve the quality and productivity of our efforts in this area. In particular, we need to keep developing our in-house expertise, make more and better use of outside experts, refine our case development strategies, and look for creative alternatives to the "trench warfare" techniques that the IRS and taxpayers now use to resolve transfer pricing cases.

Seventh, there are a number of specific steps Congress could take to improve taxpayer compliance and IRS activities in this area. Most notably:

- Make the long-term investment necessary to improve and expand IRS transfer pricing enforcement efforts. The President's 1991 budget represents an important first step down this road. Mr. Chairman, I would like to thank you and your colleagues for your support in this regard.

- Permit sole source procurement of outside experts to support IRS examination and litigation efforts. This may not sound like much, but it is probably the most important single step that Congress could take in helping us to improve our Large Case Program and enforce the law against FCCs.

- Enact those portions of H.R. 4308 that would make code section 6038A applicable to all open tax years and expand the scope of that section to cover reporting by foreign corporations with U.S. branches. The plain fact is that our ability to develop transfer pricing cases involving FCCs requires ready access to information that has been well beyond our reach.

- Enact the Administration's locality-based pay proposals. Private sector professionals handling transfer pricing cases earn many times what our employees make, particularly in high cost of living areas. We will never be competitive, but we must do better.

Finally, as I have stated, FCCs the and USCCs raise significant compliance issues in the transfer pricing arena--we believe that the U.S. government is being short-changed billions of dollars annually. Unfortunately, there are no quick fixes or easy and dramatic solutions. The IRS has been doing a good job of administering section 482 under circumstances that exist today; if Congress and the Administration take the steps I have just summarized, we can--and will--do a much better job in the years ahead.

II. OVERVIEW

The past decade has seen a dramatic increase in foreign investment in the United States. Many foreign companies have established a significant U.S. presence, and have set up U.S. subsidiaries or branches to carry on their business operations. Chart 1, which is attached to my written statement, illustrates this trend by showing the growth of assets and worldwide receipts of U.S. and foreign controlled corporations during the period 1979-87 (the last year for which we have data). The assets of FCCs grew by 368%, from $205 billion to $959 billion, while the assets of all other U.S. corporations grew by only 102%. Likewise, the total receipts of FCCs grew by 183%, from $242 billion to $685 billion, while the total receipts of all other U.S. corporations grew by only 52%. To place the 1987 numbers in perspective, $959 billion equals about six percent of the total assets of all U.S. corporations, up from 3% in 1979; $685 billion equals about seven percent of the total receipts of all U.S. corporations, up from 4% in 1979. This growth manifests the increasing importance of this area of the tax law.

Although the growth of foreign investment in the U.S. is often discussed in the transfer pricing context, the converse is equally true and well worth noting. U.S.-based corporations have a significant and growing presence overseas. Many of these corporations report a large part of their sales, or profits, outside of the United States. In fact, for those companies claiming foreign tax credits, studies show that half of their worldwide taxable income is derived from foreign sources. See chart 2, which is attached to my written statement.

A great deal of attention has been paid of late to IRS Statistics of Income (SOI) data regarding taxes paid by FCCs relative to all other U.S. corporations. This data is reflected in charts 3 through 7, all of which are attached to my written statement. Chart 3 shows the rate of return on assets for FCCs and all corporations during the period 1981-1987. Chart 4 shows total net income as a percentage of total gross receipts for FCCs and all other U.S. corporations during the same period. Chart 5 shows the increase in total receipts during the period 1983-1987 for FCCs controlled by Canadian, British, Japanese, and West German companies. Chart 6 shows net income as a percentage of total receipts for USCCs and FCCs controlled by Canadian, British, Japanese, and West German companies during that same 1983-1987 period. Chart 7 shows cumulative net income as a percentage of cumulative total receipts for FCCs and USCCs for the period 1983-1987, grouped by three types of business activity: manufacturing, wholesale and retail trade, and finance and insurance.

While there have been many assertions regarding this data, we believe it demonstrates that FCCs may be substantially understating their U.S. income tax liability. This conclusion applies with equal force to FCCs controlled by Canadian, Japanese, British and West German companies, and to each of the primary types of businesses pursued by FCCs. The data is certainly cause for concern, and those at the IRS who have been pursuing FCC transfer pricing issues since the early 1980's should be congratulated for their foresight and their activities to date. Moreover, transfer pricing adjustments that have been made or are pending against FCCs suggest that IRS concerns are well-founded.

At the same time, however, it is absolutely essential to keep two points in mind:

> First, the aggregate data does not prove widespread noncompliance by FCCs. It may be argued that the variances we

have noted could be explained by a variety of factors that have little to do with improper transfer pricing. Most notably:

The data is not adequately refined to permit direct company-by-company, business-by-business, and product-by-product comparisons that would conclusively demonstrate transfer pricing abuses;

Start-up companies tend to be less profitable than their established competitors -- a disproportionate number of FCCs may fall into the start up category, accounting for a portion of the variance. In this regard, see attached chart 8.

Perfectly legitimate differences in capital structure could also account for a portion of the variance (e.g., If FCCs are more heavily leveraged than their USCC counterparts).

Second, the IRS has encountered significant transfer pricing issues involving U.S. based multinationals. Our examination efforts to date make clear that certain of these taxpayers are also understating their tax liability and should be subject to adjustments under code section 482. We do not have aggregate USCC data of the same type as that available regarding FCCs. However, there are indications that USCCs may engage in the same type of income shifting as FCCs. In this regard, I would like to call the committee's attention to an article entitled "Transfer Pricing Issues" by Lowell Dworin, Director, Office of Tax Analysis, U.S. Department of Treasury.

Based on the foregoing, we believe that the IRS must continue to pursue a balanced enforcement strategy that deals with FCCs and USCCs in an even handed manner. At the same time, we must recognize the unique administrative difficulties that arise in dealing with FCCs as compared to their USCC counterparts. With this in mind, I would now like to describe the types of cases we encounter, the way we develop transfer pricing cases, our efforts in the area, and steps we can take to improve the way we administer code section 482.

III. TYPES OF CASES ENCOUNTERED

Code section 482 allows the IRS to look at transactions between a taxpayer and a related party to determine if the allocation of income is proper. The standard used in examining such transactions is whether they were at arm's length. This standard seeks to determine at what price, or under what conditions and arrangements, would unrelated parties agree to undertake the transaction in question. In brief, the International Examiner examines the various transactions among the related parties and attempts to determine if unrelated parties would agree to the same terms for the transaction. If the answer is no, the examiner will propose an adjustment to reallocate the income and expenses to reflect an arm's length transaction. The determination is, of necessity, based to a significant extent on information that is available only from the taxpayer being examined or, often, the foreign parent of the taxpayer.

It would be impossible to describe all of the varied factual situations in which transfer pricing issues can arise. The following examples illustrate the types of situations that are faced by International Examiners in the transfer pricing area.

First, what is the proper valuation of patent rights and other manufacturing intangibles? A U.S. pharmaceutical company has developed a new drug, for which it holds a world-wide patent. Its wholly-owned foreign subsidiary is given the right to manufacture and market the drug in Europe. After an examination of the taxpayer's records, we concluded that the drug can be manufactured for ten cents per tablet. Under its current pricing structure, the subsidiary sells the drug for fifty cents per tablet. How much of the forty cents in profits should be allocated to the parent--which is taxed by the U.S. currently, and how much to the subsidiary--the income of which is generally not subject to U.S. tax until profits are repatriated?

Second, what is the value of a trade name and servicing rights? A U.S. manufacturer of machine tools licenses its valuable brand name to a foreign subsidiary. The subsidiary produces the machinery locally, but puts the name of the U.S. parent on it. The parent provides customer and marketing support to the foreign subsidiaries. Also, the U.S. parent periodically seconds some of its engineers to help the foreign subsidiary with various problems and strategies. What is the value of the right to use the trade name, and of the services provided by the parent?

Third, how do you determine and value comparables? A foreign auto company produces plastic hubcaps for its cars outside the United States at the cost of $5 per hubcap. No other company manufactures a similar part, and none of the hubcaps manufactured domestically fit the foreign auto company's cars. Hence, there are no directly comparable products. The foreign parent sells the hubcap only through its wholly-owned distributors. It sells the hubcap for $50 to its U.S. subsidiary, which sells it to the public for $55. Should the gross profit of the U.S. subsidiary be $5 per hubcap, or a greater amount? To make a proper transfer pricing adjustment, data is needed about the cost of producing the hubcaps and the price at which the hubcaps are selling for in any comparable markets. Usually, this data is only available from the foreign parent.

Fourth, what is a fair rate of return for a distributor? Three foreign manufacturers of consumer electronics products each establish a wholly-owned U.S. subsidiary to distribute their various products in the United States. The foreign parents each sell a line of products to their U.S. distributor. The products sold are similar to that sold by the manufacturer in its home market, but each product has minor, often cosmetic, differences to distinguish the products sold in different countries.

The first foreign manufacturer sells goods to its U.S. distributor at a price which permits the subsidiary to resell them competitively with an average markup of only 15%, even though the industry average for similar distributors is 30%. With this smaller markup and the need to provide the same services as domestic distributors, the distributor has a loss or a small profit each year.

The second foreign manufacturer makes sales to its U.S. owned distributor at an arm's-length price, but requires the distributor to resell the goods at a price below the standard industry price, thereby causing the distributor to operate at a loss.

The third foreign manufacturer, as part of an unwritten agreement with the distributor, requires the subsidiary to incur substantial costs for advertising and servicing of goods under an extended warranty program, and to provide various rebates with respect to products that are not sufficiently in demand. These costs would not be incurred by unrelated domestic distributors, since they would not be willing or required to absorb the costs of extra advertising, rebates or extended warranty protection.

In each situation, the issue is what price the manufacturer should charge the wholly-owned distributor, and under what terms these sales should be made. In analyzing the profits of the foreign-owned U.S. distributor, the key question to consider in each situation is whether an independent distributor would agree to operate under such conditions. In many cases, one may conclude that the foreign parent is either overcharging the distributor for the products, or that the wholly-owned U.S. distributor is required to absorb extra costs that unrelated distributors would not agree to incur.

Fifth, can a foreign parent convert profits into interest deductions? A foreign company has had a wholly-owned U.S. incorporated distributor since 1973. For the past 15 years the distributor has not shown a profit. The figures for its 1988 tax year are typical of its profits and losses during these years. The company had gross receipts of $20 million and the costs of goods sold were $17.0 million, leaving gross income of $3 million. However, nearly all of its deductions were interest for shareholder loans and accounts payable to the parent. The bottom line is a loss of $1.0 million for 1988. Fifteen years in business and tens of thousands of the product sold in the U.S. each year--yet the distributor has never made a profit. One can reasonably question whether an unrelated distributor would agree to a purchase price that would leave it in the red for 15 years in a row. I would note that the 1989 act's "earnings stripping" provision may deny deductions for certain excess related party interest.

In framing the issues for the cases described above, information must often be obtained from the foreign parent and given to experts for analysis. For example, the examiner must determine the cost of manufacturing the product, the exact terms of the relationship between the manufacturer and the distributor, the nature of the relationship between the manufacturer and distributors in other countries and what prices are charged there. Such information is usually available only from the foreign parent, and is difficult to obtain. Also, unless individuals familiar with industry practices are available to analyze the data provided, and ask the right questions, the development of any proposed adjustments may be difficult, or impossible, to achieve.

As the above examples show, transfer pricing issues can arise in both inbound and outbound transactions. In the past, the attention of the IRS was more focused on outbound transactions because of the relatively greater number of U.S. companies doing business overseas as compared to the number of foreign corporations doing business in the United States, and the tendency of many U.S. companies to use offshore tax havens to conduct certain overseas business. While the IRS continues its emphasis on outbound transactions, the greatly increased levels of investment and business activity by foreign companies in the United States have caused greater examination efforts in this sector as well.

Examiners are encouraged to audit inbound and outbound transfer pricing arrangements. However, there are few arrangements or transactions that result in easy and uncontested adjustments to income. Even if it is agreed that an additional payment is due for various goods and services (or a reduced payment in the inbound area), it is still difficult to determine what the proper transfer price should be. Referring back to our examples, it is difficult to determine what price the U.S. drug and machine tool companies should charge their foreign subsidiaries. In the case of the hubcaps, there is no direct comparable price since the part provided is unique to the specific company The additional services provided by the electronics distributor are valuable--but the distributor has not received further compensation. In the third case, should some of the debt of the distributor be considered as equity? Also, it may be difficult for the IRS to identify the issue and quantify the proper adjustment unless an examiner is well versed in the practices of an industry. The arrangements made by taxpayers provide myriad opportunities to shift income to favored locations, and produce lower overall tax burdens. Generally, it is advantageous for a taxpayer to shift costs to high tax jurisdictions while shifting income to low tax ones.

With respect to this last observation, several points are worth noting. Canada, Japan, the United Kingdom and West Germany all have higher nominal corporate tax rates than the United States. This does not indicate that FCCs controlled by companies located in those jurisdictions have no reason to shift income out of this country. First, they may do so by way of a tax haven jurisdiction with low or no effective taxes on corporate income. Second, the income may well be shifted to a parent country with relatively high apparent tax rates for any number of reasons, including "patriotic duty," the need to compensate the country's government for nontax subsidies, or the fact that effective tax rates may be lower than nominal rates.

IV. HOW THE IRS HANDLES A TRANSFER PRICING CASE

The development and resolution of a transfer pricing matter requires IRS international examiners and other specialized personnel to obtain extensive information and conduct substantial factual development. Much of the relevant information is only available from the taxpayer, which may be very slow (or unwilling) to provide data, or may not be keeping records in a form that is usable to the IRS. The company can whipsaw the IRS by being slow to provide information while at the same time refusing to extend the statute of limitations. In such a situation, any proposed IRS adjustment might well be made on the basis of incomplete information. In turn, if we are unable to develop the case thorough discovery in tax court, the IRS is in an untenable position because only the taxpayer has the information needed to sustain the IRS proposed adjustment.

When the IRS begins an audit of a U.S. subsidiary of a foreign corporation, it may often be apparent that there is a transfer pricing issue. For example, if a distribution subsidiary has a minimal profit or a loss over a number of years, this is a tip-off to a transfer pricing issue. A company engaged in a distribution business should usually expect to command some sort of a profit. Failing to attain that, an unrelated distributor would not remain in business for long, or at the least, would change the products for which it acted as a distributor.

When the examiner believes a transfer pricing issue exists, the audit begins with an examination of the nature of the business relationship between, and the relative activities of, the parent and the subsidiary. The examiner asks the company to provide data about its product line(s), prices charged, costs and profit margins, who its competitors are and their products, and the basis on which its prices are established. An economist may be brought in to assist in the following: providing a functional analysis of the activities of the parent and subsidiary; identifying the taxpayer's competitors; estimating the appropriate economic returns which should be generated by the functions performed; identifying any comparables on which the IRS may base any proposed transfer pricing adjustment; or any of a number of other activities and analyses of the economics of the parties' transactions.

In performing a transfer pricing analysis, the examiner tries to determine the true taxable income of the foreign controlled corporation. This is the taxable income that would have been earned if the domestic subsidiary had dealt with the foreign parent, and other related entities, at arm's length. The purpose of section 482 is to placu a controlled taxpayer on a tax parity with no uncontrolled taxpayer. Hence, transactions between controlled taxpayers are subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. Our authority to determine true taxable income extends to any case in which by inadvertence, or design, the taxable income of a controlled taxpayer is different from what it would be if the taxpayer had been dealing at arm's length with an unrelated taxpayer.

Within the IRS, the International, Examination and Chief Counsel functions are involved in transfer pricing activities. In the district offices in the field, the Examination division is responsible for the audit of the taxpayer. The Assistant Commissioner (International) is primarily involved in a coordination role at the IRS National Office. Chief Counsel, which has a specific component devoted to international matters, gets involved in an audit when legal assistance is helpful or when litigation may result.

The Chief Counsel's Office of Appeals attempts to settle cases that cannot be resolved between the taxpayer and the examining agent. As of March 31, 1990, the inventory of proposed section 482 income adjustments in appeals was more than $8.6 billion. In 1989, the Office of Appeals was able to reach a settlement for about 90 percent of the adjustments involving section 482 that were being contested by the taxpayer after a determination by the examination function. In the last few years, the sustension rate of 482 cases has been between 30 and 40%. Given the limited number of these cases, the relatively recent vintage of FCC cases, and that a few cases can distort the rate, these numbers should be cited cautiously.

Litigation involving section 482 is extremely difficult, usually involving thousands of documents and long factual records. The service has had mixed results in litigation, with the courts often rejecting both the positions of the IRS and the taxpayer. Only twenty major section 482 cases have been litigated since 1964.

V. WHAT THE IRS IS DOING IN THE TRANSFER PRICING AREA

Mr. Chairman, the IRS should be congratulated for the way it has responded during the past decade to the challenges posed by the explosive growth of multinational business activity and the proliferation of international tax issues--most notably, in the transfer pricing area. Without question, we should do more, and we should do better--but I am confident that we are heading down the right road.

1. The IRS Commitment Of Resources. The IRS has made significant organizational changes and has committed additional resources to addressing international tax compliance issues. In 1986, the Office of Assistant Commissioner (International) was established to better focus and coordinate our efforts in dealing with foreign governments and the full spectrum of taxpayers involved in international transactions. At the same time, a counterpart office of Associate Chief Counsel (International) was established to achieve parallel benefits within the Office of Chief Counsel regarding international tax technical and controversy matters. While it is too early to assess the long-term impact of these organizational changes, I believe they have had a positive impact to date and will pay substantial dividends in the years ahead.

The IRS has significantly increased staffing in all functions that deal with international issues. As reflected in attached chart 9, the number of International Examiners ("IEs") has increased from 150 in 1977 to 490 this year. In this regard, you should note that the number of IEs has increased over the last two years despite the service-wide hiring freeze of the past two years. This has been accomplished by reducing revenue agent activity in other areas.

As we have stated on numerous occasions, transfer pricing issues require substantial expertise in "nontax" areas--most notably, economic analysis. With this in mind, our in-house staff of economists working international tax matters has more than doubled during the past seven years, from 14 to 35 today.

Approximately 500-600 FCCs are under audit during any given year. In most cases, the examination will involve multiple tax years. As reflected in attached chart 10, we are currently auditing approximately 520 FCCs, with approximately 1130 tax returns under consideration. For tax year 1987 returns, we currently plan to audit approximately 600 FCCs, as reflected in attached chart 11. As you will note, while this represents only 1.3% of the FCC returns, it covers those FCCs reporting more than 50% of total assets and gross receipts for that year.

During FY 1989 our IEs proposed $500 million in transfer pricing adjustments involving FCCs, and approximately $4 billion for USCCs (almost three-fourths of this $4 billion was recommended in the examination of two taxpayers, and both are contesting these adjustments in tax court). Through April of FY 1990, transfer pricing adjustments recommended by IEs are approximately $350 million for FCCs and $225 million for USCCs.

As is evident from the foregoing, the IRS has expanded its resource commitments to the international area, and is developing significant proposed tax adjustments. At the same time, however, we believe that our efforts have not kept pace with the growth in workload and the potential magnitude of noncompliance in this area. To cite but two examples, our in-house economists can handle less than one-third of the transfer pricing cases our existing group of IEs is developing. While the number of IEs increased substantially between 1977 and 1989, both the number and complexity of FCC and USCC returns has also increased.

2. Training And Tools To Do The Job Properly. Additional staffing in the international area is appropriate, it is only a small part of the overall solution. We must do more to retain our professionals and provide them with the training and tools to do their job properly.

During the past three years, we have lost more than 80 of our most experienced international examiners to retirement or--more often--jobs in the private sector. This is more than 15% of the total IE workforce. As a result, the average years of experience of our IEs has declined. In high cost of living areas (most notably, the northeastern U.S. and southern California), we have difficulty hiring and retaining expert personnel. For example, in Manhattan we currently have five economists and fifteen IE vacancies that we have been unable to fill. This is particularly troublesome because many of our most significant international examinations occur in these areas.

As we have testified on many occasions during the past year, the IRS has been unable to invest in the training and tools necessary for the long-term health of our tax system. This pattern has affected all aspects of our enforcement program--including the international area. The adverse impact of these reductions is magnified in light of the increased number of IEs and the decline in their experience levels.

While the IRS requires outside experts for many reasons in large case examination, the need is most compelling in the transfer pricing arena. Indeed, Mr. Chairman, they are absolutely essential. Let me be perfectly clear on this point-- without timely access to top flight experts during the development, settlement and (if necessary) the litigation of transfer pricing cases, we simply cannot and will not adequately protect the government's interest.

Unfortunately, our ability to obtain outside experts is limited by funding concerns and needlessly cumbersome procurement rules. Indeed, current procedures for obtaining the support of outside experts is so convoluted and unworkable that we often fail to spend all of the funds we have budgeted for that purpose. Unlike taxpayers in the private sector, we cannot just pick up the phone and hire the people we need. Instead, detailed procedures, including competitive bidding, must often be followed. The very fact of an open procurement process can compromise our case development efforts.

3. The IRS Can And Should Do Better. It is clear that resource limitations, the inability to properly compensate our employees, and the procurement process all inhibit our efforts to adequately administer the tax laws in a wide variety of areas, including FCC transfer pricing cases. Nonetheless, it is also clear that we can and should do better with what we have.

Among the many initiatives that we are pursuing, I would like to mention several that are particularly promising. First, we are revamping our training programs and developing specialists among our IEs, Appeals officers and Chief Counsel attorneys who will focus on particular aspects of international taxation. These individuals will be available to assist in working significant cases throughout the country. The era where one person could master much of the tax law has long since passed. We must centralize and focus certain of our enforcement efforts, and break down functional and geographic barriers within the IRS, to assure uniformity and quality case development.

Second, we are pursing a strategic initiative (SVC-18) focused specifically on the recruiting and retention of International Examiners. This effort should be completed by the end of the year; implementation will be a top priority in the years ahead.

Third, we must look for creative alternatives to the current "trench warfare" method of developing and resolving transfer pricing cases. At one end of the spectrum, we continue to explore alternative dispute resolution techniques (for example, binding arbitration). At the other end of the spectrum, a potentially promising effort involves an "advance determination" procedure. This avenue is similar in some respects to a private letter ruling. A taxpayer would submit specific information regarding its intercompany pricing structure and operations. The IRS would examine this data in light of the markets involved, and comparable activities performed by competitors. The taxpayer and the IRS would agree to an acceptable methodology for determining the pricing structure for specified products or product lines. Both sides would generally be bound to use that method for a stated number of years. The particular results from applying that methodology would be subject to normal examination procedures. However, since determining proper methodology is often the most difficult issue, the advance determination procedure would greatly simplify transfer pricing cases for taxpayers and the IRS alike. We are currently negotiating advance determination agreements with a number of specific taxpayers on a pilot basis, and are preparing a revenue procedure for general application.

Finally, we must be--and are--willing to ask for help from Congress in our efforts to better administer the law. With this in mind, I would like to turn to a number of legislative initiatives.

VI. LEGISLATIVE INITIATIVES

There are no quick, easy and dramatic ways to improve compliance in the transfer pricing arena. What's required is a long-term investment in top flight Administration of the tax laws. In particular:

1. The IRS Budget. The Administration's proposed FY 1991 budget for the IRS is a critical first step to maintain and enhance the health of our tax system. It will permit expansion of our enforcement efforts in a variety of areas, including transfer pricing by FCCs. Of equal importance, while it will not remedy the shortfalls of the past several years, it will begin to provide our employees with the training and tools they need to do their jobs properly.

2. Expert Witnesses. The IRS must be able to obtain the

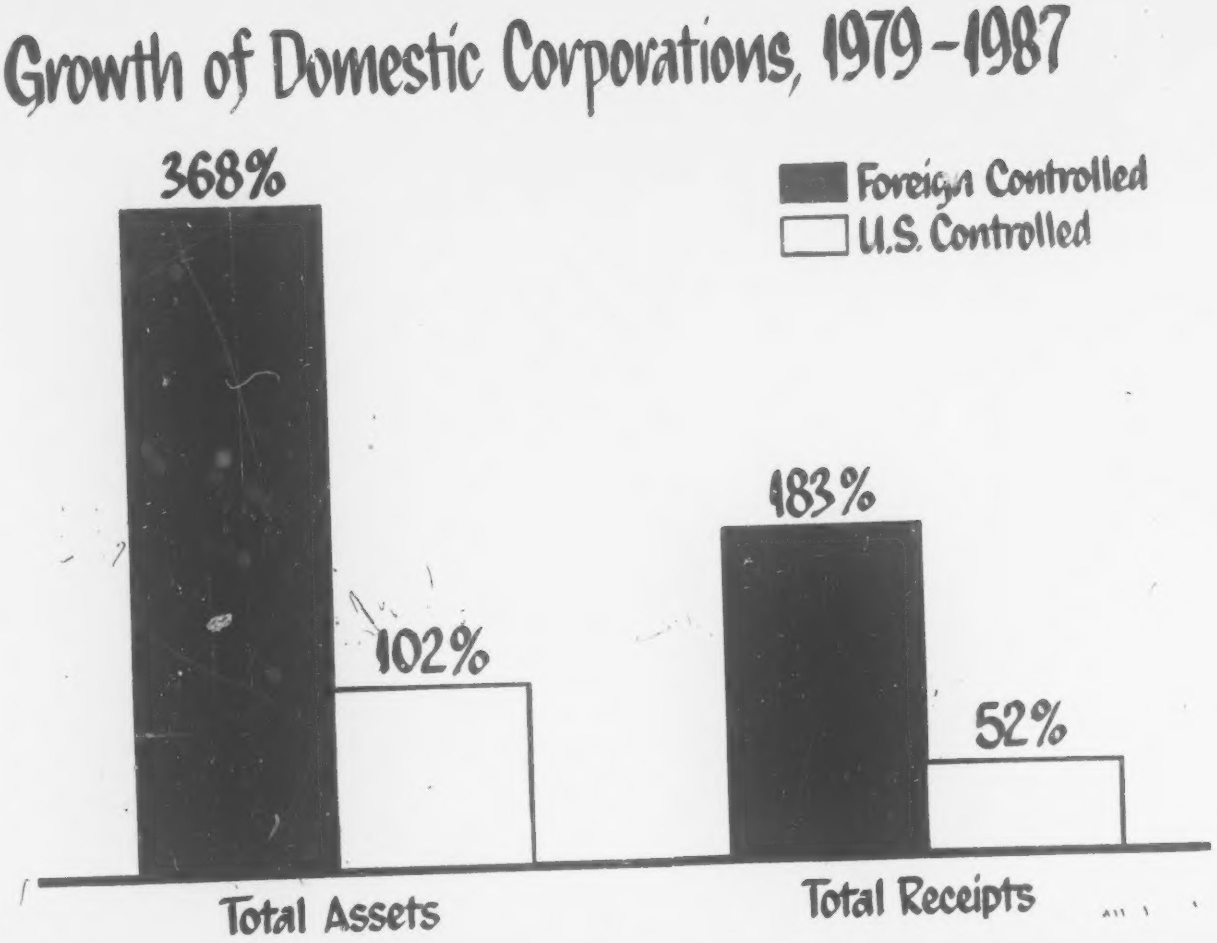
support of outside experts in developing, settling and litigating transfer pricing cases. As currently structured, this process doesn't work. If Congress is serious about dealing with compliance issues involving large corporate taxpayers (including FCCs), you will permit us to retain outside experts on a sole source, fast track basis. By way of a road map, Congress could simply parallel existing laws governing the Environmental Protection Agency's ability to hire experts for purposes of administering the Superfund provisions.

3. Access To Information. Information is the key to developing transfer pricing cases. In 1989, Congress amended code section 6038A to make it easier for the IRS to obtain information with respect to foreign controlled taxpayers. These changes were effective only for tax years beginning after July 10, 1989, and did not generally apply to foreign corporations doing business through branch operations in the United States. H.R. 4308 would extend the scope of section 6038A to cover all open tax years and clearly cover reporting by foreign corporations doing business through branch operations in the United States. We believe these two provisions would help the service do a better job in developing and closing existing cases, improve the quality of our work in the future, and help encourage up front voluntary compliance by FCCs.

4. Pay In The Public Sector. As you know, Mr. Chairman, the Administration has proposed locality-based pay for federal employees in high cost of living areas. Without question, this measure is critical to "good government" across the board. But it's more than an abstract proposition -- it's day-to-day reality. Our 15 IE vacancies make the point. Our 15% attrition among experienced IEs makes the point. Our ability to enforce the law against foreign controlled corporations is clearly and directly affected by this issue. It's time we did something about it.

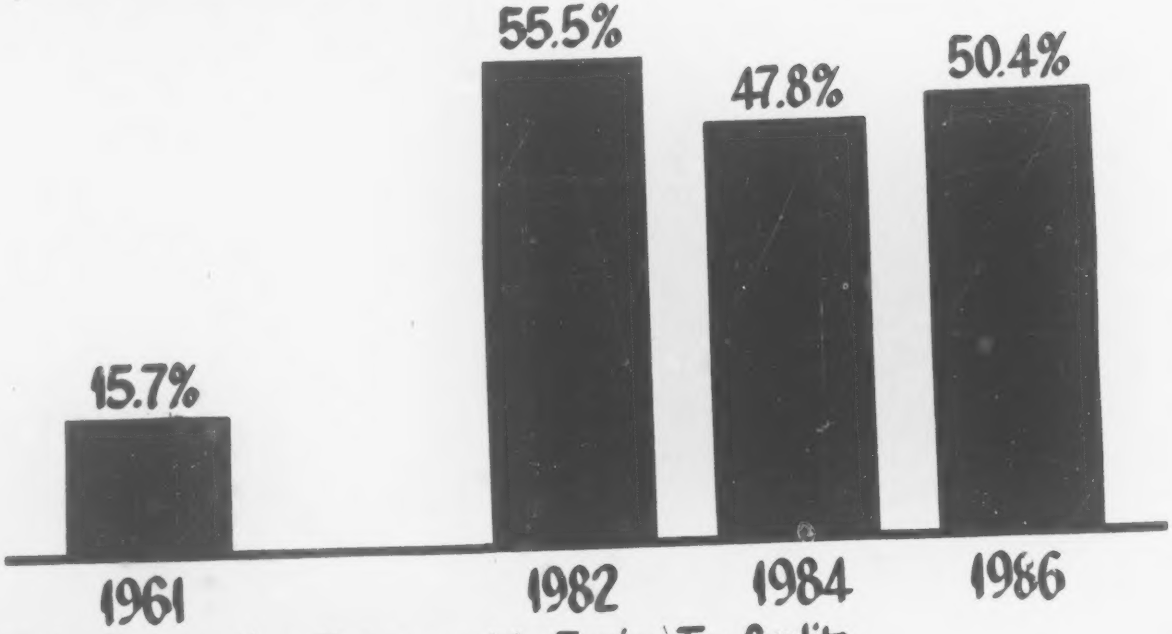
CONCLUSION

Mr. Chairman, in conclusion, I want to thank you and your colleagues for your continued support and concern for the best in tax administration. Once again, you are focusing on a matter of great significance, are properly holding us accountable for our performance, and are seeking constructive improvements to enhance compliance with our tax laws.



Growth of Domestic Corporations, 1979-1987

Foreign Source Taxable Income as a Percentage of Total Taxable Income

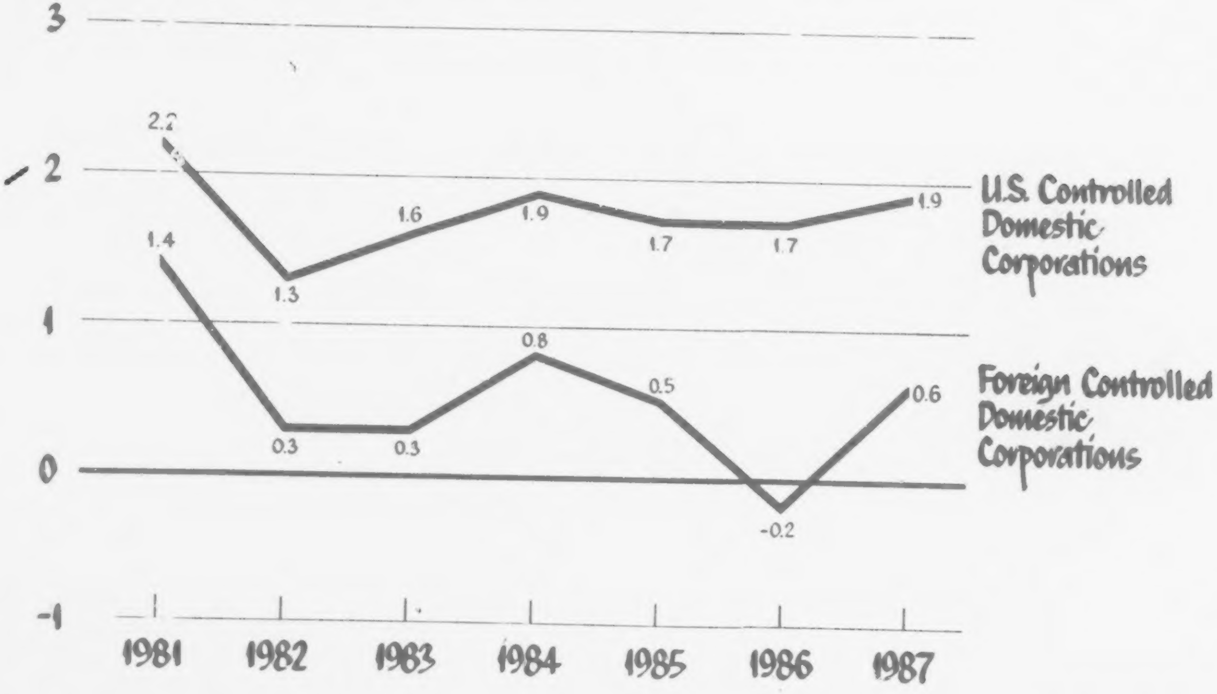


U.S. Corporation Returns with Foreign Tax Credits

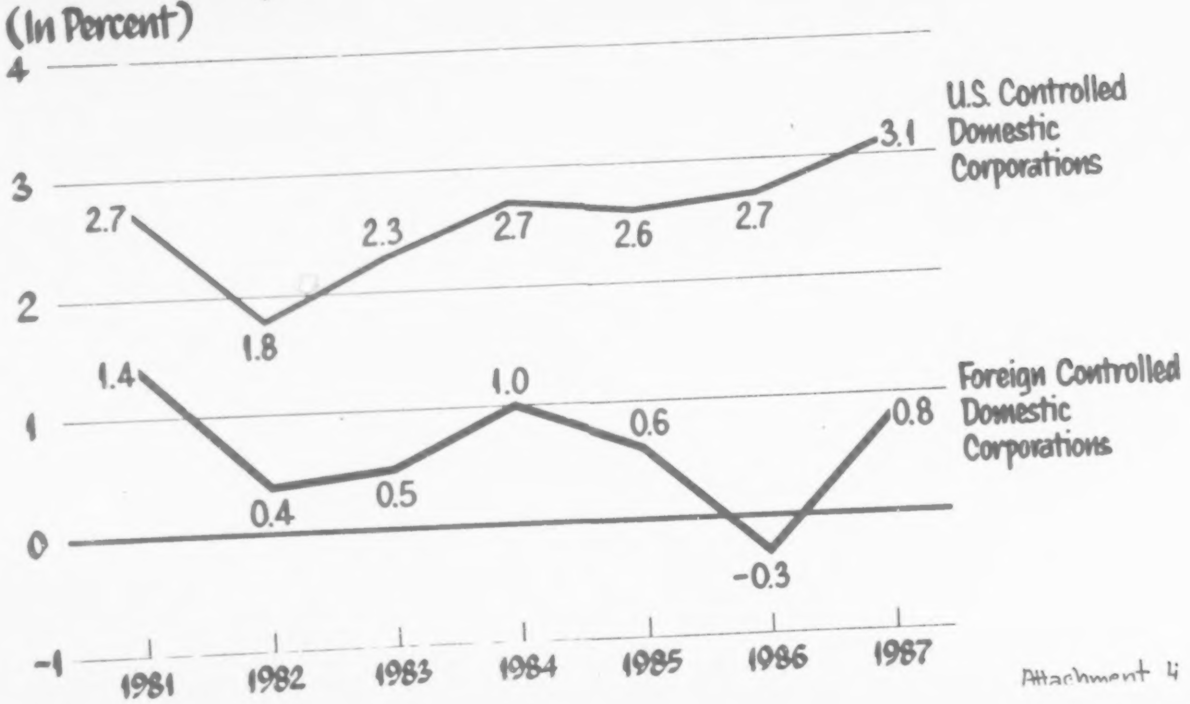
Attachment 2

Rate of Return on Assets

(In Percent)

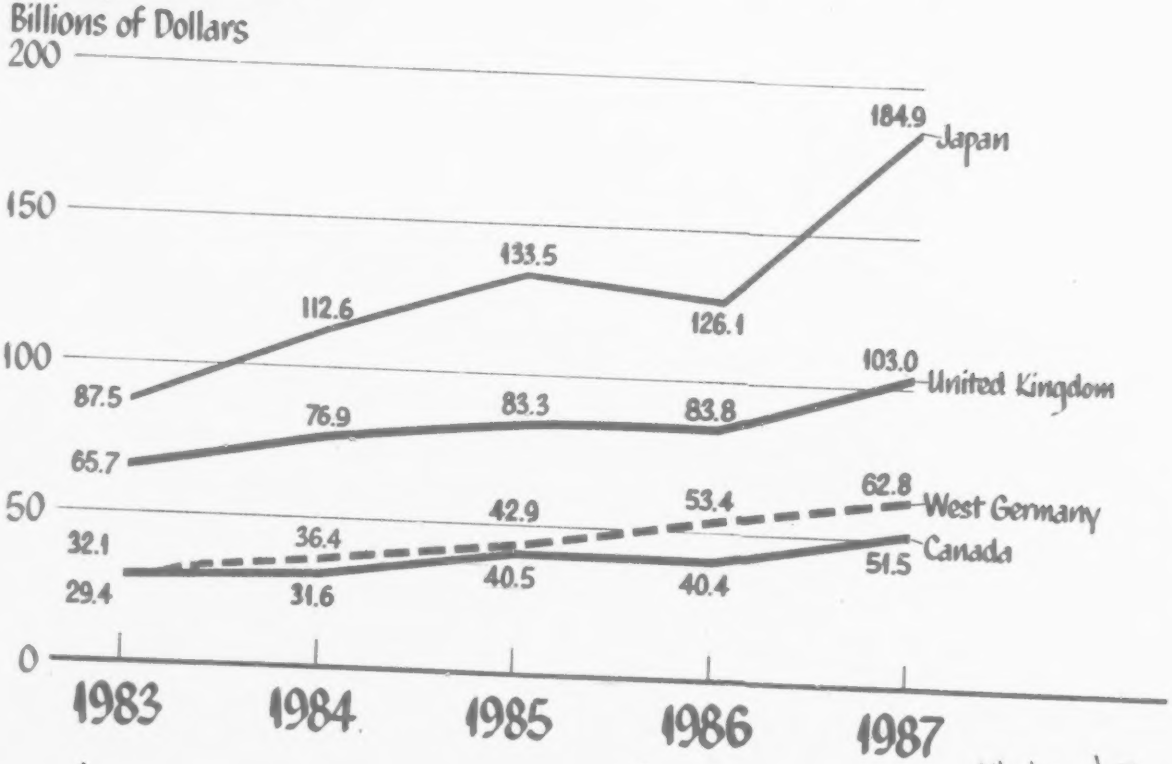


Net Income (Less Deficit) as a Percentage of Total Receipts



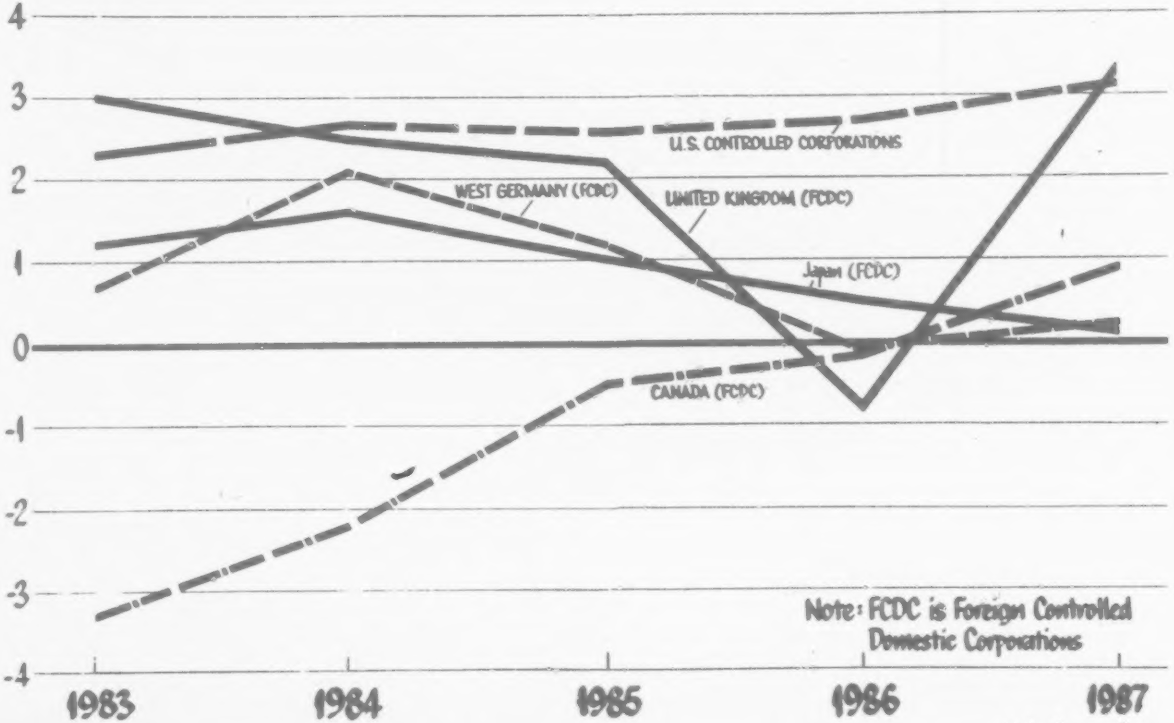
Attachment 4

Total Receipts of Foreign Controlled Domestic Corporations

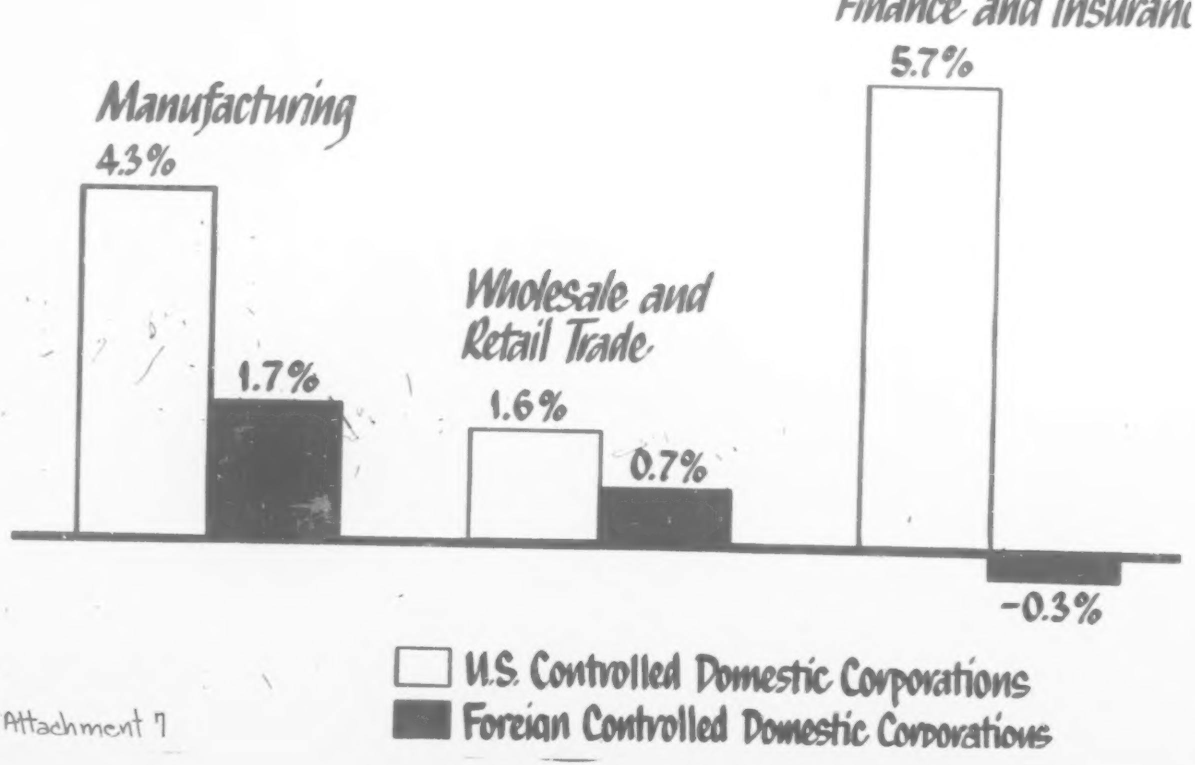


Attachment 5

Net Income (Less Deficit) as a Percentage of Receipts

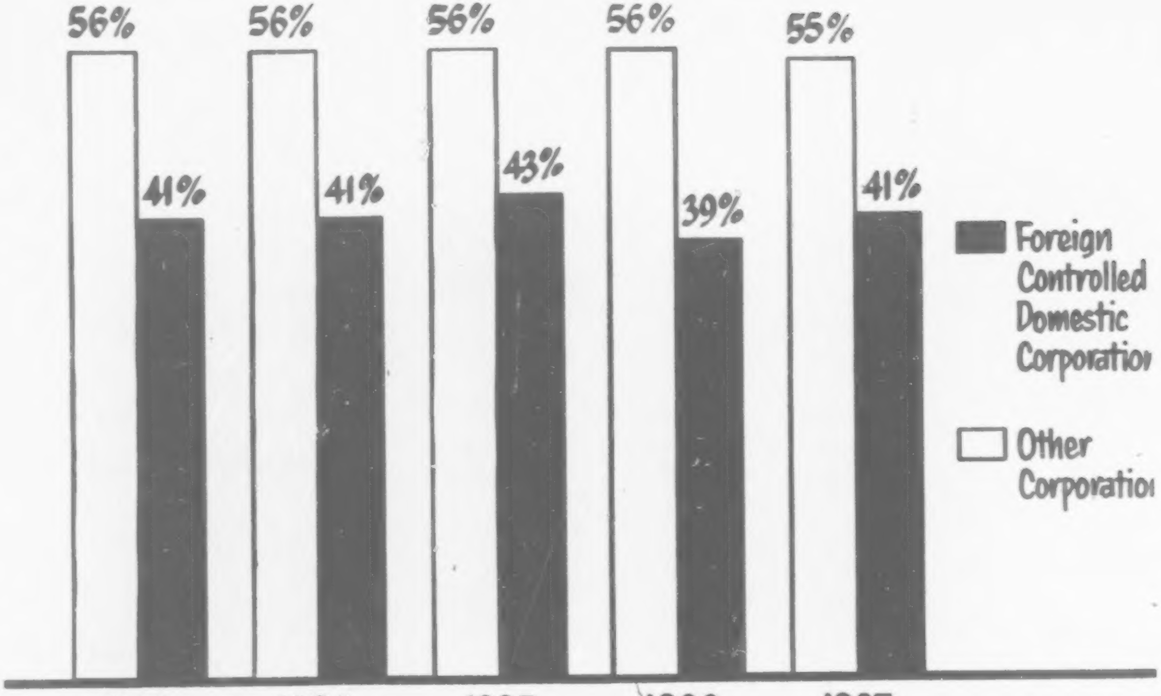


Net Income (Less Deficit) as a Percentage of Total Receipts, 1983 – 1987



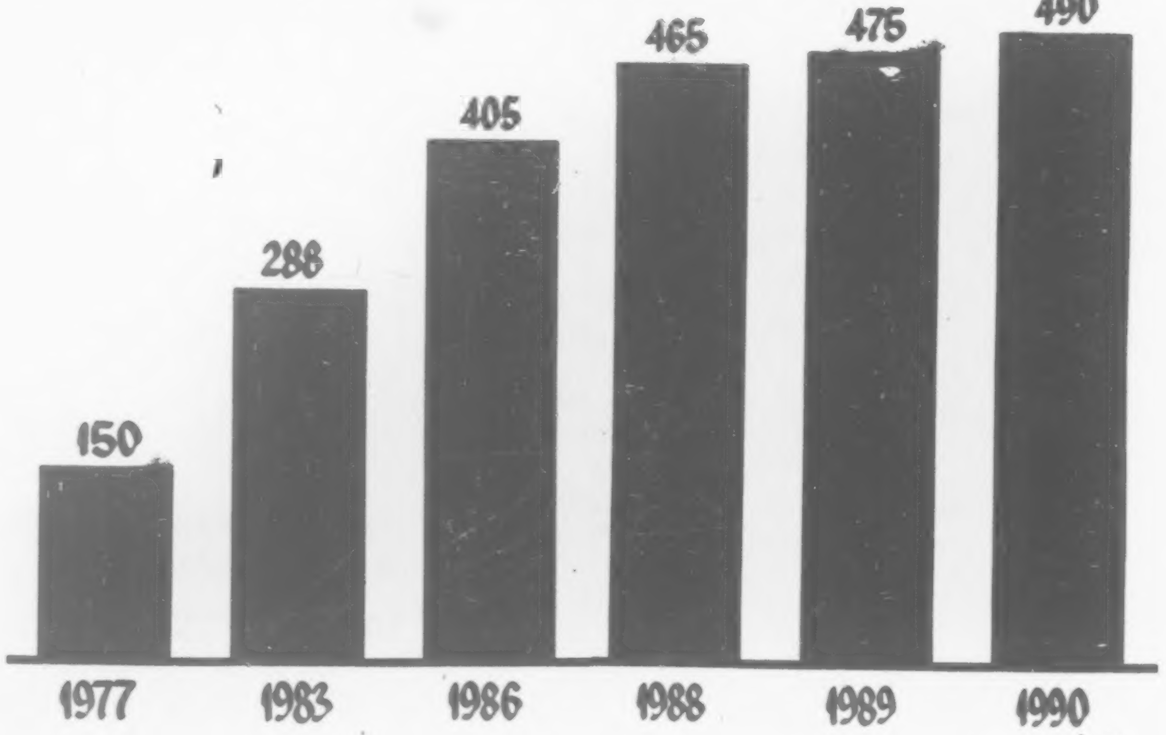
Attachment 7

Percentage of Corporations Reporting Net Income



Attachment 8

Number of International Examiners



Attachment 9

Foreign Controlled Corporation Returns Currently Under Examination

Agriculture, Forestry, Fishing, Mining, Construction, Other	Returns Gross Receipts	86 $13.0 billion
Manufacturing	Returns Gross Receipts	178 $124 billion
Transportation	Returns Gross Receipts	21 $9.9 billion
Wholesale and Retail Trade	Returns Gross Receipts	528 $523 billion
Finance, Insurance, Real Estate	Returns Gross Receipts	200 $174 billion
Services	Returns Gross Receipts	119 $53 billion
Total	Returns Gross Receipts	1132* 896.9 billion

* Approximately 520 Taxpayers

Attachment II

Examinations Planned for 1987 Foreign Controlled Corporation Returns

	Examinations Planned	Total 1987 FCC Population	Percent To Be Examined
Number of Taxpayers	600	45,000	1.3%
Total Assets	530 billion	959 billion	55%
Gross Receipts	355 billion	687 billion	52%

Attachment 11

Chairman PICKLE. Thank you, Commissioner. Now, Commissioner, we are going to ask for your agreement, if we may proceed with the next panel so that then we might come back to you and the other panelists together for further questioning. We are interested in getting everyone's statement on the record. We have spent 2 hours in closed session and would now like to hear their public statements.

So I will ask the two panels together to come up in one and make their statements, and then we will come back to you.

The Chair will ask Charles Triplett, James Kamman, Stanley Novack, Steven Zemsky, Edward Romoff, Pamela Lewin, David Lowry, Neil McNulty, Lou Milano, Patrick Kelly, and Paul Chmiel.

Mr. Triplett you may proceed.

STATEMENT OF CHARLES S. TRIPLETT, DEPUTY ASSOCIATE CHIEF COUNSEL (INTERNATIONAL), INTERNAL REVENUE SERVICE, WASHINGTON, D.C.

Mr. TRIPLETT. Thank you, Mr. Chairman and members of the subcommittee. As suggested, I will condense my statement.

You have asked me to discuss the following:

One, an overview of the IRS' international enforcement program and an analysis of the support and resources given to field personnel.

Two, examples of how taxpayers reduce U.S. tax liability in the transfer pricing area, and the relevant issues and tax cases recently litigated.

Three, the overall situation regarding inbound cases and the countries and industry types actively engaged in nonarm's-length pricing.

Four, the extent to which section 1059A has been used by the IRS.

Five, compliance and/or enforcement issues.

And six, the advance determination process.

With respect to the first point, an overview of the IRS' international enforcement program and the support and resources given to field personnel, as you just heard, the topic was extensively covered by Commissioner Goldberg and will be covered by others. I really can add little to their testimony except to provide personal perspective of what things were like 12 years ago as compared to what they are today and briefly mention the role of the Chief Counsel's Office in the International Enforcement Area.

When I started with the Service in 1977 there was little formal or informal interaction between the Examination Division and Chief Counsel's Office for the purpose of improving development of these cases. This extended to virtually all substantive tax issues. This resulted in cases being litigated that were not always ready for presentation to a court when received by counsel's office.

Some of these cases required extensive development by counsel's office after they had been docketed with the Tax Court, a situation that often depended upon the individual tolerance of a particular judge toward counsel's use of pretrial discovery.

I would add now that there is a much greater willingness and commitment on the part of the Service to utilize Chief Counsel's

Office and other expertise to develop these cases in a fashion that will produce a more accurate adjustment. Better development of transfer pricing adjustments requires an additional commitment of resources, as you have already heard.

I would also like to mention the role of the Chief Counsel's Office in this area. We now employ between 75 and 80 attorneys in the Office of the Associate Chief Counsel—International—here in Washington. We serve as the lawyers to the Internal Revenue Service for all aspects of the international tax program, including such diverse areas as drafting regulations and rulings to establishing litigating positions for foreign tax issues in the courts.

In addition, there are 10 designated International special trial attorneys around the country in our field offices that provide assistance to Exam in the development of international issues and also litigate such cases in the U.S. Tax Court. Besides them, there are several dozen other attorneys whose duties include being Counsel's contact point with Exam on international issues.

The second area you wanted me to cover was examples of how taxpayers reduce U.S.-tax liability in the transfer pricing area and the relevant issues in tax cases recently litigated. I will try to answer this question fairly broadly, as I note that several of the agents are covering the subject of inbound distributors in some detail.

In my remarks, I describe the outbound cases, and I have submitted to you a list of the 20 cases that we have tried over the last 25 years and a brief analysis of those cases, and will not repeat that here.

Jumping ahead to page 4, of the 20 opinions handed down since 1964, only three were inbound cases; that is, cases in which the parent company was a foreign based company. The Government lost all of the transfer pricing issues in these cases in the Tax Court. In these inbound cases, the court's findings basically turn on the evidence and testimony offered at trial. None of these cases, however, represent the typical inbound distributor cases the Service is actively auditing at this time.

Most of the cases involving section 482 are factually complex, requiring significant evidentiary development, and technical and scientific analysis of that evidence, in order to be decided fairly. In what may have been efforts to achieve judicial economy, many cases have resulted in decisions that represent a compromise of the position of the parties.

An unfortunate byproduct of these cases is that they may very well influence both the Government and the taxpayer to press overly aggressive positions, on the assumption that the court is going to scale back anything either side proposes.

The third area that you have asked me to cover is the overall situation regarding inbound cases and the countries and industry types actively engaged in nonarm's-length pricing.

The inbound cases will be discussed in much greater detail by the field agents, economists and lawyers who will also testify before this subcommittee. These individuals will testify regarding the particular techniques that foreign-owned companies employ to minimize the profits of their U.S. subsidiaries. The majority of the companies that are being audited are distributors. The transfer pricing issues generally involve the price of the product itself and such related issues as whether the subsidiary is being sufficiently compensated for additional functions it performs or risks it bears, such as warranty, advertising, after-sale service, et cetera.

Where there are manufacturing subsidiaries located in the United States, other issues may arise. These involve the same issues that arise in the outbound cases, for example, the royalty rate, the technical service charges, et cetera.

As far as I know, the Service does not track examination results on a country by country basis, and therefore it is difficult to answer the question of noncompliance as it applies to any particular country.

To attempt to put this into perspective, however, I looked at SOI tax return data of the foreign subsidiaries of U.S.-parent companies operating abroad. These are commonly referred to as CFC's. In particular, I looked at those located in Canada, Japan, United Kingdom, and West Germany, because those are the countries that the subcommittee asked about. For the 1982, 1984, and 1986 samples, those CFC's generally earned an 8 to 10 percent pretax net operating profit on their business receipts. Contrast this with the average of about 1 percent or less earned by the U.S. subsidiaries of foreign parents from those same four countries in those years, and it certainly suggests a problem.

It may very well be that in those years there would not have been any incentive to shift income from the United States to another high-tax jurisdiction, on the assumption that any foreign taxes paid would be fully creditable by the U.S. parent. For this reason, I think it is generally true that there is very little audit activity by the IRS with respect to those particular CFC's.

Contrast that assumption with foreign-owned subsidiaries doing business in the United States. I am frequently asked whether it makes sense for a foreign parent to shift income from the United States back to a foreign country that has as high or higher a marginal corporate income tax cost. My answer is that generally it depends on a number of factors. For example, a particular country may have tax-sharing treaties that a foreign parent company can exploit.

An area that might pose an incentive for income-shifting out of the United States is where another country has a weak or ineffective antideferral regime. Many commentators feel that the United States probably has too strong an antideferral regime and that hurts its competitiveness. In such a case the foreign parent might choose to invoice goods through a tax haven trading company in order to book excessive profits there. Note that this may not directly impact the income of the U.S. subsidiary.

Finally, there might be special tax incentives in a foreign jurisdiction that encourage shifting of profits away from the United States, or there might be something as simple as an expiring net operating loss that the parent wants to use.

The fourth area is the extent to which section 1059A has been used by the Service. In this section I describe some of the issues that arise under section 1059A. Our experience to date has been somewhat limited because the effective date was in 1986. So therefore, I will jump to page 6 and section 5, compliance and/or enforcement issues.

Again, many of these issues have already been or will be mentioned by other witnesses, particularly Commissioner Goldberg. Certainly two high priority reforms would include giving the Service the ability to expeditiously hire expert witnesses, and extending the effective date of section 6308A to all open tax years.

Another area that we find problematic is our ability to secure third party comparable information. This information is critical to the Service's ability to enforce section 482 and other provisions of the Internal Revenue Code. As you know, the operative standard for examining related party transactions is to determine whether those transactions are equivalent to arm's-length transactions between unrelated parties.

In some situations, such as with interest charges, the necessary comparable information is available from public sources. However, in many instances, public information is nonexistent or is in a format that does not permit an accurate comparison to the transactions of the taxpayer under investigation.

In order to have a reasonable opportunity to administer section 482, the Service must have the ability to secure third party comparable data, and to use such third party comparable data—which, by necessity, entails disclosing it to the taxpayer under investigation.

Currently, section 7602(a)(2) provides that the Service may summons information from "any other person the Secretary may deem proper." We recognize that this language is certainly broad enough to encompass summonses to third party comparables. However, the Service has had legitimate concerns about exercising this authority because it can be invasive to the party who has no connection or relationship with the taxpayer under investigation.

While the Service has enjoyed considerable success in securing the voluntary cooperation of third party witnesses, those witnesses have frequently expressed concerns about the potential for damage in disclosing trade secret information either to the public or to the taxpayers, who typically may be a competitor of the third-party witness.

We are sympathetic to the concerns of those third-party witnesses and are working to balance such concerns with the interests of tax administration.

There are two other areas that I believe are worth mentioning today. I will cover one here and the other in the final portion of my prepared testimony. The first area involves a provision allowing the Service unilaterally to extend the statute of limitation on assessment—a proposal contained in the pending legislation.

The problem with the proposal, as Treasury has noted, is that in its present format it would only apply to foreign-owned operations doing business in the United States. Treasury has legitimate reservations that this would be discriminatory with respect to our treaty partners. I believe that further consideration should be given to following the recent lead of Canada and provide for an extension of the statute in both foreign-owned and domestic-owned contexts.

Some may suggest that this would exacerbate the competent authority process since it would extend an already lengthy examination process. I do not share this view because I do not believe the right to extend the statute would be exercised in many cases. At the present time, we are encountering what seems to be an increasing number of cases of taxpayers refusing to extend the statute of limitations—in both foreign-owned and domestic-owned situations. Invariably such cases involve transfer pricing issues and the refusals to extend the statute seem to coincide with a taxpayer's refusal to provide the Service with requested information or documentation.

Admittedly, taxpayers have legitimate concerns with the inconvenience and expense of interminable examinations, just as the Service does. But oftentimes, given the uncertainty of obtaining extensive factual development of these cases before the Tax Court, additional time to develop the cases administratively on audit is warranted and would benefit the tax system and ultimately all taxpayers.

I believe that if taxpayers knew they could no longer succeed by engaging in a strategic waiting game with the Service, then their responses to information would be much more forthcoming. For these reasons, I believe that providing the Service with the ability to extend the statute of limitations, in both inbound and outbound situations, is worthy of consideration.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF

CHARLES S. TRIPLETT

DEPUTY ASSOCIATE CHIEF COUNSEL (INTERNATIONAL)

BEFORE THE SUBCOMMITTEE ON OVERSIGHT

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

Mr. Chairman and Members of the Subcommittee:

This statement has been prepared in accordance with the letter dated June 7, 1990, from Congressman J. J. Pickle, Chairman, Subcommittee on Oversight, to Fred T. Goldberg, Jr., Commissioner, Internal Revenue Service, regarding your hearings on tax underpayments by U.S. subsidiaries of foreign-owned companies and other related compliance issues.

My name is Charles S. Triplett. I am the Deputy Associate Chief Counsel (International) of the Internal Revenue Service, and I have held that position since it was created in March of 1986. I came to the Service in 1977 and was assigned as a docket attorney to the Tax Litigation Division in the Chief Counsel's National Office. In that capacity, I had my initial exposure to transfer pricing cases and Section 482. My principal role was in developing positions to be taken in litigation and reviewing briefs to be filed with the U.S. Tax Court. After several years, I was given the opportunity to actively assist in the litigation of two of the largest transfer pricing cases ever undertaken by the Service.[1] This effort lasted almost three years on a full-time basis -- interspersed by some limited involvement in legislative and regulatory attempts to deal with the transfer pricing problem as it was perceived in the early part of the last decade. In 1983 I was promoted to the position of Special Trial Attorney. After a year in that capacity, I was asked to come back to the National Office and organize a branch to deal with the tax shelter problem. Two years later I was appointed to my present position.

You have asked me to discuss the following:

1) An overview of the IRS's international enforcement program and an analysis of the support and resources given to field personnel;

2) Examples of how taxpayers reduce U.S. tax liability in the transfer pricing area, and the relevant issues and tax cases recently litigated;

3) The overall situation regarding "inbound" cases and the countries and industry types actively engaged in non-arm's length pricing;

4) The extent to which Section 1059A has been used by the IRS;

5) Compliance and/or enforcement issues; and

6) The advance determination process.

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[1] Eli Lilly v. Commissioner, 84 T.C. 996 (1986), aff'd in part; rev'd in part and rem'd 856 F.2d 855 (7th Cir. 1988); G.D. Searle v. Commissioner, 88 T.C. 252 (1987).

1) An overview of the IRS's international enforcement program and an analysis of the support and resources given to field personnel.

This topic is extensively covered by Commissioner Goldberg and others, and I can add little to their testimony except to provide my personal perspective of how things were twelve years ago compared to what they are like today, and to briefly mention the role of the Chief Counsel's office in the international enforcement area.

When I first started with the Service, there was very little formal or informal interaction between Exam and Counsel for the purpose of improving the development of transfer pricing cases. This phenomenon was not just limited to transfer pricing -- it extended to virtually all substantive tax issues. This resulted in cases being litigated that were not always ready for presentation to a court when received by Counsel's office. Some of these cases required extensive development by Counsel's office after they had been docketed with the Tax Court, a situation that often depended upon the individual tolerance of a particular judge toward Counsel's use of pre-trial discovery.

I do not by implication intend to criticize the Service's deployment of its limited resources a dozen years ago, however, the cases audited today are far more complicated in their facts and economics. Now, there is a much greater willingness and commitment on the part of the Service to utilize Counsel and other expertise to develop these cases in a fashion that will produce a more accurate adjustment. Better development of transfer pricing adjustments requires an additional commitment of resources, as you will undoubtedly hear from other witnesses.

I would also like to mention the role of the Chief Counsel's office in this area. We now employ between 75 and 80 attorneys in the Office of the Associate Chief Counsel (International) here in Washington. We serve as the lawyers to the Internal Revenue Service for all aspects of the international tax program, including such diverse areas as drafting regulations and rulings to establishing litigating positions for foreign tax issues in the courts. In addition, there are ten designated International Special Trial Attorneys around the country in our field offices that provide assistance to Exam in the development of international issues and also litigate such cases in the U.S. Tax Court. Besides them, there are several dozen other attorneys whose duties include being Counsel's contact point with Exam on international issues.

2) Examples of how taxpayers reduce U.S. tax liability in the transfer pricing area and the relevant issues and tax cases recently litigated.

I will try to answer this question fairly broadly as I note that several of the agents are covering the subject of inbound distributors in some detail.

While the focus of this hearing is on foreign-owned businesses operating in the United States, for the sake of completeness I will briefly describe the issues surrounding U.S.-owned multinational businesses.

The classic "outbound" transfer pricing issue involves the development of valuable technology in the United States and the subsequent transfer of that technology to a tax haven manufacturing subsidiary. For many years, these transfers were generally made tax-free. Significant income distortions thus resulted until, if ever, profits were repatriated to the U.S. parent company in the form of dividends. The distortions occurred in part because the U.S. parent company typically incurred, and currently deducted, the oftentimes considerable expense of developing the technology, while the foreign manufacturing subsidiary enjoyed very large profits, at a minimal current tax cost if it was established in a tax haven.

In 1982, Congress amended section 936 of the Internal Revenue Code to curtail this abuse as it existed with respect to "possession corporations." These companies typically operate in the U.S. possession of Puerto Rico. The legislative action in 1982 was a response to the types of cases I just described, wherein the U.S. parent companies transferred valuable patents to their subsidiaries operating in Puerto Rico without any tax being paid on the transfers. The subsidiaries then claimed very large profits after they manufactured the products, typically pharmaceuticals, and sold them back to the United States. The companies thus tried to avoid the payment of any taxes on these profits, and, in some cases, shifted so much income to the Puerto Rican operation that the parent companies were in loss positions with respect to their U.S. tax returns. This was because the parent companies continued to expend large sums for research and development expenses and other normal operations without the profits available from the successful products to fund such expenditures. Litigation of these types of cases resulted in the sustention of only about half of what the Service proposed in its deficiency notices.

The 1982 legislation prevented a possession corporation from claiming any of the income attributable to transferred intangibles unless they elected one of two options. One of these options is the 50-50 profit split and is relatively straightforward except for the sometimes difficult task of computing "combined taxable income." Since half of this income will not be taxed in the U.S., the taxpayer obviously is interested in maximizing the resultant sum and the IRS will look to assure that all of the appropriate expenses are associated with the amount. The other option entails computing a cost-sharing payment from the subsidiary and then allocating the manufacturing intangible income to the subsidiary and the non-manufacturing intangibles to the parent. This has proven to be very difficult to administer and resulted in the anomalous situation of some companies claiming even greater possessions income than before the 1982 legislation. In 1986, however, Congress specifically dealt with this problem when it again amended section 936 to incorporate the so-called "superroyalty" as a baseline in computing the cost-sharing payment.

Meanwhile, Congress also recognized that problems remained in the tax-free transfer of intangibles to other low tax jurisdictions besides Puerto Rico, and accordingly amended section 367(d) in 1984 to prevent this abuse. Most of these manufacturing subsidiaries were located in countries where they were able to secure significant benefits, tax and otherwise, in order to induce them to establish operations there and employ local workers.

The one notable area of abuse that still invited transfer pricing schemes was later addressed by Congress in 1986, when it amended sections 482, 367 and 936 to incorporate the "commensurate with income" standard. Congress was aware that it was difficult to find legitimate comparables to administer the arm's length standard incorporated in the regulations under section 482. The legislative history associated with the 1986 tax act was particularly critical of those taxpayers that attempted to rely on industry averages to establish royalty rates for extremely successful and profitable products. The reason for this criticism was that the average rates never reflected rates for the high-profit products, since these tended to be exploited within a corporate group and not licensed between unrelated parties. Thus, the industry "norm" tended to be unrealistically low, and did not represent a true "arm's-length" charge.

A particular case singled out for criticism in the 1986 Act legislative history was U.S. Steel Corp.[2] There, the Second Circuit Court of Appeals essentially rejected any economic analysis that distinguished the tremendous differences in the volume of business undertaken between the subsidiary and the parent versus the volume between the subsidiary and unrelated parties.

The most recent case decided by the Tax Court in this area is the Bausch & Lomb[3] case. The staff of this Subcommittee has been briefed about this case in some detail.

The Bausch & Lomb case involved the following. The parent company owned the patent rights to valuable technology that allowed it to make soft contact lenses at considerable savings over its competitors. The parent decided to form a manufacturing subsidiary in Ireland for the initial purpose of making lenses for other B&L distributors in Europe. Within a few months after opening its Irish facility, the parent decided that Ireland should also provide lenses for the U.S. market as well. The original profit projections that led to the establishment of a 5% royalty rate were thus immediately outdated. The IRS contended in Tax Court that the parent company would never have paid $7.50 to an unrelated party to make a contact lens when it could make one itself for $1.50. We also argued that the royalty rate charged the Irish subsidiary was inadequate to compensate the parent for the use of such valuable intangible rights.

It is a puzzling opinion in that, while the court rejected most of the government's arguments, it seems to endorse much of the analysis provided in the "White Paper" on intercompany pricing prepared by the Treasury and IRS and submitted to Congress on October 18, 1988. We have appealed the case to the Second Circuit Court of Appeals. It should be noted that the 1986 Act should render much of the court's analysis moot.

There have only been twenty[4] transfer pricing cases litigated within about the last twenty-five years. I have briefly described several of these cases and they were all "outbound" cases. Another outbound case worthy of mention is the DuPont case, where the taxpayer attempted to shift large profits to a foreign distributor located in a tax haven.[5] The court rejected the taxpayer's evidence of comparability. Instead it accepted the testimony of the government's experts that essentially corroborated the Service's adjustments by using macroeconomic data rather than pure comparables.

Of the twenty opinions handed down since 1964, only three[6] were "inbound" cases. The government lost all of the transfer pricing issues in these cases in the Tax Court. In these inbound cases, the court's findings basically turn on the evidence and testimony offered at trial. None of these cases, however, represent the typical inbound distributor cases the Service is actively auditing at this time.

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[2] U.S. Steel Corp. v. Commissioner, T.C. Memo 1977-140, rev'd 617 F.2d 942 (2d Cir. 1980).

[3] Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), appeal filed by Commissioner December 11, 1989, (2d Cir., No. 89-4156).

[4] There have actually been a few more than twenty, but the others involved domestic taxpayers with relatively small adjustments. Those issues do not generally arise anymore after the enactment of section 269A in 1982.

[5] E.I. DuPont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979).

[6] R.T. French Co. v. Commissioner, 60 T.C. 836 (1973); Nissho Iwai American Corp. v. Commissioner, T.C. Memo 1985-578; and Ciba-Geigy Corp. v. Commissioner, 85 T.C. 172 (1985).

Most of the cases involving section 482 are factually complex, requiring significant evidentiary development, and technical and scientific analysis of that evidence, in order to be decided fairly. In what may have been efforts to achieve judicial economy, many cases have resulted in decisions that represent a compromise of the position of the parties.[7] An unfortunate byproduct of these cases is that they may very well influence both the government and the taxpayer to press overly aggressive positions, on the assumption that the court is going to scale back anything either side proposes.

3) The overall situation regarding "inbound" cases and the countries and industry types actively engaged in non-arm's length pricing.

The "inbound" cases will be discussed in much greater detail by the field agents, economists and lawyers who will also testify before this Subcommittee. These individuals will testify regarding the particular techniques that foreign-owned companies employ to minimize the profits of their U.S. subsidiaries. The majority of the companies that are being audited are distributors. The transfer pricing issues generally involve the price of the product itself and such related issues as whether the subsidiary is being sufficiently compensated for additional functions it performs or risks it bears, such as warranty, advertising, after-sale service, etc.

Where there are manufacturing subsidiaries located in the U.S., other issues may arise. These involve the same issues that arise in the "outbound" cases, *e.g.*, the royalty rate, the technical service charges, etc.

As far as I know, the Service does not track examination results on a country by country basis, and therefore it is difficult to answer the question of non-compliance as it applies to any particular country.

To attempt to put this into perspective, however, I looked at SOI tax return data of the foreign subsidiaries of U.S. parent companies operating abroad. These are commonly referred to as "CFCs." In particular, I looked at those located in Canada, Japan, United Kingdom and West Germany. For the 1982, 1984 and 1986 samples, those CFCs generally earned an eight to ten percent pre-tax net operating profit on their business receipts. Contrast this with the average of about 1 percent or less earned by the U.S. subsidiaries of foreign parents from those same four countries in those years, and it certainly suggests a problem.

It may very well be that in those years there would not have been any incentive to shift income from the U.S. to another high-tax jurisdiction, on the assumption that any foreign taxes paid would be fully creditable by the U.S. parent. For this reason, I think it is generally true that there is very little audit activity by the IRS with respect to those particular CFCs.

Contrast that assumption with foreign-owned subsidiaries doing business in the United States. I am frequently asked whether it makes sense for a foreign parent to shift income from the U.S. back to a foreign country that has as high or higher a marginal corporate income tax cost. My answer is that generally it depends on a number of factors. For example, a particular country may have tax-sparing treaties[8] that a foreign parent company can exploit. An area that might pose an incentive for income-shifting out of the U.S. is where another country has a weak or ineffective anti-deferral regime. In such a case the foreign parent might choose to invoice goods through a tax haven trading company in order to book excessive profits there. Note that while this would not directly increase the profits of the foreign parent, it would still decrease the income of the U.S. subsidiary. Finally, there might be special tax incentives in a foreign jurisdiction that encourage shifting of profits away from the U.S., or there might be something as simple as an expiring net operating loss that the parent wants to use.

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[7] But, *cf.*, *Buffalo Tool & Die v. Commissioner*, 74 T.C. 441, 452 (1980), where the court essentially directed the parties to resolve a valuation question amongst themselves, or else the court might be inclined to pick one of what it considered to be two extreme positions.

4) The extent to which Section 1059A has been used by the Service.

Section 1059A was enacted in the Tax Reform Act of 1986. It provides that a U.S. taxpayer that imports property into the U.S. in a transaction (directly or indirectly) from a person or persons related to the taxpayer, within the meaning of section 482, may not claim, for purposes of computing the basis or inventory cost of the property, a greater cost than the amount of the cost taken into account for customs valuation purposes. Final regulations for section 1059A were published in the Federal Register on September 8, 1989.

Section 1059A has a relatively narrow focus -- that is, to prevent the Federal government from being whipsawed by an importer, on property acquired from a related party, by claiming a low valuation for customs purposes and a higher valuation for tax purposes.

The Service uses section 1059A whenever it can effectively do so. It should be noted, however, that section 1059A has its limitations. For example, the section has no application to property not subject to any customs duty or to property not subject to an ad valorem customs duty. Moreover, because the rules for determining the value of imported property for customs purposes differ in some respects from the rules for determining cost basis or inventory cost for income tax purposes, certain adjustments to the customs value are required to determine the limitation to cost basis or inventory cost for income tax purposes. Finally, consider the case of property imported in open transactions in which the actual purchase price is determined from events occurring after the date of importation. In many instances, Customs requires duty to be paid on such property at the time of importation on the basis of a deductive or imputed value. This often results in actual purchase prices being greater than, or less than, the customs value. In these cases section 1.1059A-1(c)(9) of the Regulations allows an averaging of customs values.

We have experience with only a few cases involving section 1059A at this time. As we examine more tax years to which the section applies, we expect to see a growing number of cases.

5) Compliance and/or enforcement issues.

Many of these issues have already been or will be mentioned by other witnesses, particularly the Commissioner. Certainly two high priority reforms would include giving the Service the ability to expeditiously hire expert witnesses, and extending the effective date of section 6038A to all open tax years. The latter provision has already been proposed and is currently pending before Congress.

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[8] These refer to the situation where one country will give its taxpayers foreign tax credits for "phantom" taxes that another jurisdiction forgives. The United States has steadfastly refused to negotiate tax sparing into its tax treaties.

Another area that we find problematic is our ability to secure third party comparable information. This information is critical to the Service's ability to enforce section 482 and other provisions of the Internal Revenue Code. As you know, the operative standard for examining related party transactions is to determine whether those transactions are equivalent to "arm's-length" transactions between unrelated parties. In some situations, such as with interest charges, the necessary comparable information is available from public sources. However, in many instances, the information publicly available is nonexistent or is in a format that does not permit an accurate comparison to the transactions of the taxpayer under investigation.

In order to have a reasonable opportunity to administer section 482, the Service must have the ability to secure third party comparable data, and to use such third party comparable data -- which, by necessity, entails disclosing it to the taxpayer under investigation.

Currently, section 7602(a)(2) provides that the Service may summons information from "any other person the Secretary may deem proper." We recognize that this language is certainly broad enough to encompass summonses to third party comparables. However, the Service has had legitimate concerns about exercising this authority because it can be invasive to the party who has no connection or relationship with the taxpayer under investigation. While the Service has enjoyed considerable success in securing the voluntary cooperation of third party witnesses, those witnesses have frequently expressed concerns about the potential for damage in disclosing trade secret information either to the public or to the taxpayer, who typically may be a competitor of the third party witness.

We are sympathetic to the concerns of those third-party witnesses and are working to balance such concerns with the interests of tax administration.

There are two other areas that I believe are worth mentioning today. I will cover one here and the other in the final portion of my prepared testimony. The first area involves a provision allowing the Service unilaterally to extend the statute of limitation on assessment -- a proposal contained in the pending legislation. The problem with the proposal, as Treasury has noted, is that in its present format it would only apply to foreign-owned operations doing business in the United States. Treasury has legitimate reservations that this would be discriminatory with respect to our treaty partners. I believe that further consideration should be given to following the recent lead of Canada and provide for an extension of the statute in both foreign-owned and domestic-owned contexts. Some may suggest that this would exacerbate the competent authority process since it would extend an already lengthy examination process. I do not share this view because I do not believe the "right" to extend the statute would be exercised in many cases. At the present time, we are encountering what seems to be an increasing number of cases of taxpayers refusing to extend the statute of limitations -- in both foreign-owned and domestic-owned situations. Invariably such cases involve transfer pricing issues and the refusals to extend the statute seem to coincide with a taxpayer's refusal to provide the Service with requested information or documentation. Admittedly, taxpayers have legitimate concerns with the inconvenience and expense of interminable examinations, just as the Service does. But oftentimes, given the uncertainty of obtaining extensive factual development of these cases before the Tax Court, additional time to develop the cases administratively on audit is warranted and would benefit the tax system and ultimately all taxpayers. I believe that if taxpayers knew they could no longer succeed by engaging in a strategic "waiting game" with the Service, then their responses to information would be much more forthcoming. For these reasons, I believe that providing the Service with the ability to extend the statute of limitations, in both inbound and outbound situations, is worthy of consideration.

6) The advance determination process.

You have heard described, from myself and others, the difficulties encountered by the Service in its attempt to monitor transfer pricing, both from an inbound and an outbound perspective. Some have recently complained about the administrability of the "arm's-length" standard and urged that we abandon it in favor of some sort of a formulary approach that would provide more certainty.

I can tell you unequivocally that I believe the arm's-length standard is the best approach among alternatives that I have seen and that any formulary approach can be just as difficult to administer and can produce more arbitrary results.

Rather than adopt a formulary approach to transfer pricing, I believe the application of the arm's-length standard can be enhanced greatly through the development of a procedure for advanced determinations. There are a number of taxpayers who are indifferent to which jurisdiction taxes them, just as long as they are taxed no more than once on the same item of income. There is reason to believe that those taxpayers may be very interested in a process for determining the proper arm's-length price in advance. The details and procedures of the process are still being reviewed. We are working toward the issuance of a Revenue Procedure which will provide guidance on this subject. In brief, the process will be designed to allow a taxpayer to seek advance confirmation regarding the transfer pricing methodology it intends to employ. Ideally, that confirmation will come not only from the IRS, but also from the relevant treaty partners involved. In this fashion, it is expected that this process can serve as an alternative to competent authority disputes.

We believe that this process can ultimately reduce and conserve valuable IRS resources because it will reduce the time spent on auditing these taxpayers years after the facts arose. It will also assist us in information-gathering because both the taxpayer and the Service will have the opportunity to discuss in advance what documents need to be retained.

In short, this process has something for both a taxpayer and the Service, as long as the taxpayer is not interested in artificially shifting income from one taxing jurisdiction to another. I am very optimistic about the chances for success with this program.

Thank you for the opportunity to address you today.

Chairman PICKLE. Your entire statement will appear in the record. Let me say to the other panelists that when you start testifying the green light will come on, and within 4 minutes the yellow light will come one, and within 5 minutes the red light will come on, and that is when you are through.

We will include your entire statement in the record.

The next panelist will be Mr. James Kamman.

STATEMENT OF JAMES M. KAMMAN, INTERNATIONAL SPECIAL TRIAL ATTORNEY, INTERNAL REVENUE SERVICE, LAGUNA NIGUEL, CALIF.

Mr. KAMMAN. Thank you, Mr. Chairman, and members of the subcommittee.

I will try to get through my statement as quickly as possible.

I am an International Special Trial Attorney in the Office of Chief Counsel. I have been with counsel since 1977.

I have been actively involved in transfer pricing cases for the last 6 years and special trial attorney for the last 3 years.

Now, on my statement on page 1, it has been my experience that these cases are some of the most factually and legally challenging cases presently in the tax system. In order to properly develop these cases, whether through litigation or settlement, it is necessary for the IRS personnel to be knowledgeable and capable of integrating multifaceted disciplines such as law, tax, accounting including financial statement analysis, especially economics.

We have got to learn special industries, foreign culture and institutions, law and accounting. Commissioner Goldberg touched on this.

It is impossible to do this unless the IRS can attract, train and retain quality people. It will do us no good to hire people that will not stay with us after they are trained.

Most 482 cases and other large case taxpayers are centered in the metropolitan areas where the salary discrepancies not only between the Federal sector and private sector, but also between the Federal sector and local government are a vast chasm.

An example of this discrepancy is where my neighbor's daughter who finished her first year in law school was earning more as a summer law intern than I earned as one of the senior trial attorneys at chief counsel. I know I am not worth what the outside bar makes, but I think I am worth more than a first year law student to the tax administration system.

Most first-year associates throughout the country in large- and medium-size firms are paid more than I am.

A further example of low Federal pay was touched upon this morning by Mr. Heck and other people. Orange County was hemorrhaging their senior attorneys, district attorneys, public defenders and county counsel. Their starting salary right now is $42,000 a year.

Chief counsel hires attorneys at less than $30,000. By April of 1992, the county of Orange is going to hire first-year attorneys at $49,000.

We will probably be a little above $30,000. That is a 60-percent discrepancy in starting salary.

Senior trial attorneys in the county of Orange now make approximately $82,000 going to over $90,000 in 1992. Again the discrepancy is 25 to 30 percent above Government counsel.

Besides these professionals, revenue agents, economists we need to get clerical support to work these cases in Los Angeles and Laguna Niguel, we have a special salary structure for clerical.

This salary structure for my secretary runs between $19,000 and $24,000 at the top. That is a step 10 of the grade level.

Legal secretaries in southern California, starting legal secretaries start at $2,000 to $2,500 a month. Paralegals in Los Angeles, the top paralegals, and there is more and more of them, make more than I do as a senior trial attorney.

Commissioner Goldberg touched upon the necessity to be able to hire on a speedy basis outside economists early in development. My statement on page 2 talks about this.

All I can say is that current statutory contracting requirements are the most frustrating and bureaucratic I have dealt with in my 13 years with the IRS and the previous 4 years with the U.S. Marine Corps.

It is absolutely exacerbating trying to hire an outside expert. I am not a man of great patience, as many people will tell you.

In representing the IRS in these cases, I am opposed by taxpayers who hire some of the most prestigious and largest law firms in the country. These law firms can quickly call upon human, financial and other resources in contrast to the slow procedures Government lawyers must suffer.

It is not unusual for me to walk into a conference with the international examiner, probably the economist and me, facing a senior partner, junior partner, associate, several employees of the taxpayers and accountants from what used to be one of the big 8 firms.

This experience has been characterized, and I believe this comes from the Commissioner, as David versus Goliath, only in this instance the Government is David and you forgot to give us the slingshot.

To say we might be outmanned and outresourced in some of these cases is an understatement. In addition to the substantial cadre of legal talent, taxpayers have the ability to quickly hire outside economists and the accounting support.

The accounting support is essential because it gives the taxpayer the capability to develop data bases and accounting records to substantiate their pricing cases.

The need for additional pay, staffing and resources is accentuated by the magnitude of the compliance problem. I think Commissioner Goldberg touched upon this.

I think Mr. Triplett touched upon this. In most of the cases I am working on taxpayers have been able to eliminate or practically eliminate all taxes.

Their elimination of these taxes are not due to tax incentives properly allowed by the code, such as accelerated depreciation or investment tax credit. These taxpayers are selling goods at a price that they can not cover their costs and make a profit.

Transfer pricing issues are manifested in a number of different ways. Some of the taxpayers sell products for less money than they pay for them.

Other taxpayers may sell the products for more than the transfer price but they spend more money to sell each product than they obtain in sales revenue.

Their unit of cost for advertising, salaries, general administrative expenses, plus the transfer price makes it impossible for them to make a profit. A simple example of this is where a taxpayer buys a product from a parent at $8, spending $3 in order to sell it for $10, the taxpayers basically losing $1 on each product.

In once instance, one taxpayer showed a budgeted loss for a 6-year period.

At this time I believe I have sufficient experience, knowledge and confidence to competently represent the IRS. When I started in 1984, this was not the case. I had senior people to train me.

These senior people are now gone. We are losing the bulk of our experience. Commissioner Goldberg touched on this. We cannot afford to lose 15 percent of our most senior international examiners or 10 percent of our senior trial attorneys.

The success rate in litigation has not been very good. Recovery rates and our success in litigation can be improved if we are able to attract, train and retain good people, hire economists early in the development of the cases to assist in developing a coherent economic theory and in record gathering.

I would like to make one final comment. I believe I will probably be the only one who says this.

Although I do not want to minimize the difficulties and the complexity of these cases, I do believe that 482 in its present form is administrable and workable.

Thank you.

[The prepared statement follows:]

Orange County, California, the county in which Laguna Niguel District is located, to its attorneys. The Office of Chief Counsel pays entry level attorneys a little less than $30,000.00 a year. Orange County's starting salary for public defenders, district attorneys and county counsel, is $41,580.00, which will increase to $49,486.00 by April, 1992. This starting salary is presently a third greater than that for Government attorneys and will be approximately two thirds more by April, 1992. Likewise, the senior trial attorneys for the County of Orange currently earn $80,000.00 a year, increasing to $92,426.00 in April of 1992. Orange County recently instituted a new trial grade in an attempt to retain its most senior trial attorneys. The present salary is now $82,248.00 increasing to $94,967.00 a year in April, 1992. These senior trial salaries are presently 25 percent more than my salary and will be approximately a third more in April, 1992. These are local Government salaries and these salary discrepancies permeate the Federal pay scales and apply to accountants, economists, international examiners, revenue officers and revenue agents.

482 cases are essentially economic cases. They require the expertise and assistance of economists at all levels of development. Often the court cases hinge upon the credibility of the economic expert's testimony at trial. The Internal Revenue Service needs the authority to expeditiously hire outside economists. In addition to the authority to quickly hire outside economists without the current "red tape" burdens, sufficient funds must be allocated to hire experts prior to litigation. In the 482 area, there is a small cadre of what are referred to as forensic economists. These economists have a prior working knowledge of 482, are intellectually capable, extremely articulate, and are experienced in litigation, an absolutely essential quality if the Government is to prevail, as it should, in these cases. Because the same economists often show up on both sides of the table, the Internal Revenue Service must be able to hire them early in the development of the cases to ensure their availability as well as ensure coherent and consistent economic theories.

The current statutory contracting requirements for hiring outside economists has been an excruciating, time consuming and frustrating process. One instance in Laguna District took in excess of a year to advertise and hire an outside expert because of the statutory requirements of soliciting and reviewing bids.

In representing the Internal Revenue Service in these cases, I am opposed by taxpayers who have retained some of the most prestigious and largest law firms in the country. These law firms can quickly call upon a wealth of human, financial and other resources, in contrast to the slow and cumbersome procedures which government lawyers must suffer. It is not unusual for me to walk into a conference with the international examiner and the economist while facing a senior partner, a junior partner, an associate, several employees of the taxpayer and accountants from a "big 8" firm. This experience has been characterized recently to me as David versus Goliath, only in this instance, David is without the slingshot. To say we might be outmanned and outresourced in some of these cases is an understatement. In addition to the substantial cadre of legal talent, taxpayers also have the ability to quickly hire outside economists and accounting support. The accounting support gives taxpayers the capability of developing data bases and accounting records to substantiate their pricing cases.

The need for additional pay, staffing and resources is accenuated by the magnitude of the compliance problem. Most of the taxpayers which I am involved with have paid little or no taxes over a period of years. The reduction or elimination of taxes is not due to any tax incentives allowed by the code, such as accelerated depreciation or investment tax credit. These taxpayers are not manufacturers with heavy investment in plant and machinery. Instead, these taxpayers are distributors which can only make a profit by selling products for more than it costs them to acquire and market the products. In addition, many of these companies have had billions of dollars in sales in the same years in which they have eliminated or paid minimal taxes.

The transfer pricing issue is manifested in a number of different ways. Some of the taxpayers actually sell the products for less money than they pay their foreign parent for the same products they are selling. Other taxpayers may sell the products for more than the transfer price; but they spend more money to sell each widget than they obtained in sales revenue: their unit costs for advertising, salaries, general and administrative expenses plus the transfer price is more than the product can be sold for in the marketplace. A simple example of this is a company that buys a widget from its parent for $8, sells it in the marketplace at $10, but must spend $3 in other expenses in order to sell the widget. In this example, the taxpayer is spending $11 to sell a product for $10. My father, who spent 40 years in the retail garment business, would explain this phenomena of losing money on every item but making it up in volume. I have heard similar justification from some of these taxpayers. In other instances, taxpayers are forced to buy inventory from the parent even though the inventory cannot be sold either in a timely fashion or without discounts, rebates and the carrying charges. The carrying charges are warehouse or high interest expenses. Again, the companies lose money because their costs, whether it be advertising, interest, salaries or the actual transfer price of each product, are such that they simply cannot make a profit at the price the products will command in the marketplace. In many instances these taxpayers know, before they purchase the products, that they will lose money on the sales. In one case, the taxpayer's budgeted projections showed a loss on their business for a 6-year period.

I believe I have sufficient experience, knowledge and confidence to competently represent the Internal Revenue Service in these cases. When I started in 1984, I had little experience, training or background in 482. I had no one to assist me other than the Internal Revenue Service agents who were auditing the cases. In fact, the International Examiner and an International Examiner Group Manager who provided me support and helped teach me 482 will be testifying later this afternoon. The problem is that this type of experience is no longer available. I presently have attorneys who assist me with some of these cases, but these attorneys only have 2 or 3 years experience. Most International Examiners will only work one 482 case because of the difficulties and problems. The economists' salaries are such that the turnover and experience level of economists is as bad as in any other areas. This lack of experience definitely has an impact on the government's recovery rate and ability to develop cases.

Because of the complexities and difficulties in developing the issues, 482 cases are extremely difficult to sustain in litigation. The difficulty in acquiring and obtaining the necessary informational records from the taxpayer adds to the uncertainty. In almost every one of the cases I worked, foreign based documentation has not been obtained in a timely fashion or at all. These problems may be mitigated through Code section 6038A. Section 982 is helpful, but it needs some additional teeth. The Service could benefit by expansion and clarification in the summons area for access to foreign based documentation and third-party comparable information.

The success rate in litigation has not been very good. Recovery rates and our success in litigation can be improved if we are able to attract, train and retain good people, hire economists early in the development of the cases to assist in developing a coherent economic theory and in record gathering; and finally by obtaining quick access to records with the statutory tools for information gathering given to us by Congress. I believe the recovery rate will be improved, if only because the 482 adjustment is better developed and more accurate.

One final comment is appropriate. Although I do not want to minimize the difficulty and challenge of these cases nor the necessity for additional resources, staffing and statutory tools, I personally believe 482 and the arm's length standard are administrable and workable.

This concludes my formal statement. Thank you.

Mr. DORGAN [presiding]. Mr. Novack.

STATEMENT OF STANLEY E. NOVACK, DIRECTOR, OFFICE OF INTERNATIONAL PROGRAMS, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.

Mr. NOVACK. In respecting the time, I would like to start with page 2. For my testimony today I will address the treaty administration aspect as it relates to the resolution of double taxation cases—often referred to as competent authority program.

Over the past 3 decades, as new technology has proliferated and globalization of the economy has become a reality, our 38 tax treaties and 8 tax information exchange agreements have played an ever-increasingly important role in the conduct of international business. By removing the negative connotation of double tax and by providing mutual relief from double taxation, treaties promote business, trade and financial relationships between countries.

Unfortunately, in some cases national laws and business customs may preclude the successful alleviation of double taxation.

To deal with inconsistencies between U.S. tax law and the laws of its treaty partners, tax treaties provide an administrative mechanism through the mutual agreement procedure. This procedure provides for the competent authorities of the respective treaty countries to endeavor to resolve any differences or difficulties which may arise.

In resolving these problems the U.S. competent authority strives to achieve a balance between protecting the revenue and relieving double taxation, which includes acting as the advocate of U.S. taxpayers in seeking administrative relief in foreign countries.

As Assistant Treasury Secretary for Tax Policy, Kenneth Gideon, stated before the Senate Committee on Foreign Relations:

> The competent authorities are empowered to resolve disputes which arise under a treaty, thus giving potential investors a place to turn in the event of a conflict with host country tax authorities.
>
> We believe that this is an important benefit of treaties and we are working to make the process more accessible to taxpayers.

An example of a competent authority issue would be transfer pricing adjustments which reduce the price of goods.

If the adjustments are initiated by the United States and are considered proper by the U.S. competent authority, the treaty partner must be convinced that it has received an overpayment of taxes. If the adjustments are initiated by a treaty partner, the U.S. competent authority must be convinced that the United States received an overpayment of taxes.

Accordingly, the negotiating process is difficult because we are dealing with two quite different tax systems and often an inherent conflict of interest between the two countries in either preserving or acquiring the same item of revenue.

In addition, the United States and foreign interpretation of treaty rules and terminology frequently vary.

The competent authority issue becomes the jurisdiction of the U.S. competent authority when the U.S. taxpayer makes a request for assistance. The negotiation process begins with an evaluation of the issue along with all related facts. The IRS district having jurisdiction of the taxpayer's return assists in this evaluation.

We have had a few instances where taxpayers have gone to State or Treasury during this process. However, in such instances the taxpayers were properly referred to the U.S. competent authority for resolution of their concerns.

Negotiations are initiated by a detailed position paper that presents the basis for the adjustments and requests that correlative adjustments be granted.

Additional correspondence between the competent authorities may be necessary which is usually followed by face-to-face negotiations conducted by our Revenue Service representative or personnel from our Treaty Division.

When tentative agreement is reached, documents finalizing the agreement are exchanged by the competent authorities. This is followed by documents that provide closing instructions to the taxpayer and the IRS field office having jurisdiction of the taxpayer's return.

This process can take months or years depending on the complexity of the issue, treaty partner cooperation and the difficulties encountered during the process including issues secondary to the transfer pricing adjustment being negotiated.

The interest problem is an example of the difficulties that can arise during the negotiation process. The U.S. generally charges interest on tax deficiencies and pays interest on tax refunds while many of our treaty partners do not.

Accordingly, where a treaty partner provides a correlative deduction but not interest on the tax refund, the ultimate relief provided the taxpayer is diminished and case negotiations can be delayed.

An approach to this problem are bilateral agreements with our treaty partners that are reciprocal and balanced. At this time we have not reached any bilateral agreements on the charging and paying of interest.

The number of competent authority cases handled has remained fairly constant for a number of years. Currently we have 277 cases in process.

The majority of these cases are 482-type relating to transfer pricing involving goods and services, royalties and management fees. During fiscal year 1989 we received 90 new cases and closed 122. To date this fiscal year, we have received 65 new cases and closed 96.

For fiscal year 1989, taxpayers received full relief from double taxation for adjustments of $222.5 million, which represented 78 percent of the total dispositions; partial relief in the form of foreign tax credit was provided in 17 percent of the dispositions totaling

$49 million; and no relief was provided in 5 percent of the cases with adjustments of $14 million.

In the first 2 quarters of the current fiscal year, the figures are comparable: full relief of $139 million representing 72 percent; partial relief of $46 million representing 24 percent; and no relief for $7 million representing 4 percent.

I thank you for giving me the opportunity to discuss this important area of international tax administration.

[The prepared statement follows:]

STATEMENT OF

STANLEY E. NOVACK

BEFORE THE

OVERSIGHT SUBCOMMITTEE

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify today about the IRS's administration of the tax laws dealing with international transactions. My name is Stanley E. Novack, and I am currently employed by the Internal Revenue Service as Director, Office of International Programs, which is a component of the Office of the Assistant Commissioner (International). As Office Director, I have the responsibility for primarily four functions: 1) administration of the IRS overseas post system; 2) national oversight of, and field assistance to, the International Enforcement Program (which consists of approximately 500 international examiners located in field offices throughout the nation); 3) IRS representation during negotiations of U.S. tax treaties and agreements and, as staff to the U.S. Competent Authority, resolution of double taxation issues; and 4) the exchange of information activities under the tax treaties and similar arrangements.

As background, my experiences in the IRC 482 area encompass 14 years of my 29-year career with the Internal Revenue Service. My association with the international tax area has exposed me to various complex and highly technical tax issues, such as inbound/outbound transfer pricing of tangible goods and intangibles, foreign tax credits, Subpart F, and more recently, those related to Foreign Controlled Corporations.

My managerial responsibilities over those 14 years have included supervising the development of tax issues providing national program direction to the International Enforcement Program, negotiating income tax conventions and tax exchange information agreements, resolving double taxation cases, and working with the Associate Chief Counsel (International) and the Treasury Department on technical matters.

I have also represented the Internal Revenue Service at various meetings of tax treaty partners and at meetings of the Organization for Economic Cooperation and Development (OECD). At those meetings, I have presented the IRS views on double taxation matters and various international tax issues, including those dealing with transfer pricing and techniques used by the IRS during transfer pricing audits.

To highlight my IRS career, I joined the Internal Revenue Service in 1961 and until 1975, I was an examiner for most of that time in the Coordinated Examination Program (Large Case). In 1975, I became an International Group Manager in the Chicago District, supervising the audit activities of several international examiners. In 1978, I joined the National Office Examination function as a Senior Program Analyst in the International Programs Section where I primarily conducted International Enforcement Program field reviews. From 1979-1983, I was Key District Program Manager (International) in Indianapolis.

I again became actively involved with the national policy direction of the International Enforcement Program when I was selected in 1983 as Chief of the International Programs

Section at the National Office. From 1985-1987, I was a Large Case Branch Chief in the Chicago District. In 1987, I came to the Office of the Assistant Commissioner (International) as the Director, Office of Tax Treaty and Technical Services. In 1989, as a result of a consolidation of office directorships, I became the Director, Office of International Programs; in that capacity I assumed national program responsibility of both the International Enforcement Program and the administration of the tax treaty provisions dealing with double taxation and exchanges of tax information.

For my testimony before the you today, I will address the treaty administration aspect of my responsibilities as they relate to the resolution of double taxation cases. (Often referred to as Competent Authority Program.)

Over the past three decades, as new technology has proliferated and globalization of the economy has become a reality, our 35 tax treaties and 8 Tax Information Exchange Agreements have played an ever increasingly important role in the conduct of international business. By removing the negative connotation of double tax and by providing mutual relief from double taxation, treaties promote business, trade and financial relationships between countries. Unfortunately, in some cases national laws and business customs may preclude the successful alleviation of double taxation.

To deal with inconsistencies between U.S. tax law and the laws of its treaty partners, tax treaties provide an administrative mechanism through the Mutual Agreement Procedure. This procedure provides for the "competent authorities" of the respective treaty countries to endeavor to resolve any differences or difficulties which may arise. In resolving these problems the U.S. Competent Authority strives to achieve a balance between protecting the revenue and relieving double taxation, which includes acting as the advocate of U.S. taxpayers in seeking administrative relief in foreign countries.

As Assistant Treasury Secretary for Tax Policy, Kenneth Gideon, stated before the Senate Committee on Foreign Relations:

> "The competent authorities are empowered to resolve disputes which arise under a treaty, thus giving potential investors a place to turn in the event of a conflict with host country tax authorities. We believe that this is an important benefit of treaties and we are working to make the process more accessible to taxpayers."

An example of a competent authority issue would be transfer pricing adjustments which reduce the price of goods. If the adjustments are initiated by the U.S. and are considered proper by the U.S. Competent Authority, the treaty partner must be convinced that it has received an overpayment of taxes. If the adjustments are initiated by a treaty partner the U.S. Competent Authority must be convinced that the U.S. received an overpayment of taxes. Accordingly, the negotiating process is difficult because we are dealing with two quite different tax systems and often an inherent conflict of interest between the two countries in either preserving or acquiring the same item of revenue. In addition, the U.S. and foreign interpretation of treaty rules and terminology frequently vary.

The competent authority issue becomes the jurisdiction of the U.S. Competent Authority when the U.S. taxpayer makes a request for assistance. The negotiation process begins with an evaluation of the issue along with all related facts. The IRS district having jurisdiction of the taxpayer's return assists in this evaluation. Within the last ten years, we have had a few instances where taxpayers have gone to State or Treasury during this process. However, in such instances the taxpayer was properly referred to the U.S. Competent Authority for resolution of their concerns.

Negotiations are initiated by a detailed position paper that presents the basis for the adjustments and requests that correlative adjustments be granted. Additional correspondence between the competent authorities may be necessary which is usually followed by face-to face negotiations conducted by our Revenue Service Representatives or personnel from our Tax Treaty Division. When tentative agreement is reached, documents finalizing the agreement are exchanged by the competent authorities. This is followed by documents that provide closing instructions to the taxpayer and the IRS field office having jurisdiction of the taxpayer's return. This process can take months or years depending on the complexity of the issue, treaty partner cooperation and the difficulties encountered during the process including issues secondary to the transfer pricing adjustment being negotiated.

The interest problem is an example of the difficulties that can arise during the negotiation process. The U.S. generally charges interest on tax deficiencies and pays interest on tax refunds while many of our treaty partners do not. Accordingly, where a treaty partner provides a correlative deduction but not interest on the tax refund, the ultimate relief provided the taxpayer is diminished and case negotiations can be delayed. An approach to this problem are bilateral agreements with our treaty partners that are reciprocal and balanced. At this time we have not reached any bilateral agreements on the charging and paying of interest.

The number of competent authority cases handled has remained fairly constant for a number of years. Currently we have 277 cases in process. The majority of these cases are 482-type relating to transfer pricing involving goods and services, royalties and management fees. During fiscal year 1989 we received 90 new cases and closed 122 cases. To date this fiscal year, we have received 65 new cases and closed 96.

For Fiscal Year 1989; 1) taxpayers received full relief from double taxation (i.e. the taxpayer paid tax to only for adjustments of $222.5 million, which represented 78% of the total dispositions; 2) partial relief in the form of foreign tax credit was provided in 17% of the dispositions totaling $49 million; and 3) no relief was provided in 5% of the cases with adjustments of $14 million. In the first two quarters of the current fiscal year, the figures are comparable: full relief of $139 million representing 72%; partial relief of $46 million representing 24%; and no relief for $7 million representing 4%.

Statistics relating to the sustention of Section 482 adjustments by Competent Authority are only available from October 1988 to date. For cases closed during this period, the amount of recommended Section 482 adjustments and the amount sustained was as follows:

	FY 89	FY 90	Total
Recommended	$68,580,235	$69,979,179	$138,559,414
Sustained	24,443,639	57,587,883	82,031,522
Percentage	35.6%	82.3%	59.2%

Please note that these sustention statistics represent only U.S. initiated cases while those I mentioned earlier relate to all closed cases, both U.S. and foreign initiated cases.

We have taken steps in recent years to improve the resolution of double tax cases. They include: greater use of the competent authority analysts to discuss cases (face-to-face) with the treaty country, establishment of controls in the field to ensure expeditious handling of information needed by the U.S. competent authority, discussions with treaty partners to explore ways to address issues within a reasonable time-frame, keeping Treasury better informed on obstacles encountered with treaty countries. It should be noted the our initial use of analysts in face-to face negotiations with Canada has proved very successful with most cases being resolved in a timely fashion. Other examples include the development of the advance determination procedures and establishment of de minimis guidelines.

We should also note that the IRS and Treasury have established a Competent Authority Task Force to further recommend changes to the process. Practitioners have also contributed to the Task Force. The Task Force has developed a new revenue procedure relating to the competent authority process. The revenue procedure will be issued in the near future, and not only will update our current procedures, but also will include several policy decisions relating to the resolution of competent authority cases.

I thank you for giving me the opportunity to discuss this important area of international tax administration.

Mr. DORGAN. Mr. Zemsky.

STATEMENT OF STEVEN M. ZEMSKY, ECONOMIST, WASHINGTON OFFICE OF THE BALTIMORE, MD., DISTRICT, INTERNAL REVENUE SERVICE

Mr. ZEMSKY. I work as an economist in the Washington Office of the Baltimore District of the Internal Revenue Service.

IRS economists have functioned as an inhouse consulting group since 1963 to supplement, through economics, the legal and accounting skills of other Service personnel. The creation of a group of economists within the IRS have been recommended by the Treasury Department to improve the analysis of issues and development of cases. The work has included intercompany pricing as well as other issues. A small group of economists, numbering from 4 to 10 people, was located in the National Office of IRS in Washington and provided assistance throughout the country.

In 1979, the economic assistance program was expanded by adding economists in field locations. Economists have always been a free resource. That is their time is not charged to the case on which they are working. This is expected to change in the near future with the economist's time being tracked and charged to the cases.

Earlier in the program, requests for assistance originated on an exception basis. Increasingly, with mandatory referral of cases, requests have been repetitive for examinations of the same taxpayers and issues, with a resulting strain on the limited economist manpower.

The chronology of an economist's participation in a case under examination is as follows: After receiving a request for economic assistance, a determination is made as to whether an economist will participate. A meeting is held with the examination team assigned to the case to determine if the issue in the request is economic in content and is properly characterized and if other economic issues exist. The international examiner on that team is the primary interface for the economist. Financial and operational information previously obtained by the international examiner is reviewed by the economist. At one time such information, in general, was fully developed prior to the economist's involvement. Increasingly, it is done after his participation has begun and by him. Additional information and document requests are submitted to the taxpayer. Subsequent meetings, including several with the taxpayer and his operating personnel, will be held to determine the taxpayers and related company functions and operations. Visitations to taxpayer locations other than the corporate offices, including foreign trips, are often necessary to fully understand the taxpayer's operations. The economist develops an approach to the issue; researches public information; identifies comparables from taxpayer-supplied information, as well as public and private sources; and, with the international examiner, quantifies any appropriate adjustment. If an adjustment is warranted, the economist will prepare a report supporting that adjustment.

The difficulties encountered by the economist while participating in examinations fall primarily in two areas; those caused by the taxpayer and those caused by the Service.

Taxpayers often delay in responding to requests for information. These delays sometimes put time pressure on the closing of the case and may limit the time available for research on the issue and preparation of reports. Taxpayers sometimes claim that requested information either is no longer available or never existed. Additionally, foreign-owned taxpayers will usually claim that information requested concerning the parent or other related company with whom they have transactions is unavailable. This lack of information may prevent the economist from gaining a clear understanding of the taxpayer's operations and hamper the focus of his research. When taxpayers, or their related companies, have supplied data on comparability for the transactions in question, it usually has been for differentiated products and/or at the wrong level of market.

The Service provides the economist with little or no resource support. For instance, while the unit was in the national office, an economic research assistant aided the economists in securing information from public sources and preparing statistical analyses directed by the economists. Also, graduate economics students served as summer interns and were assigned research projects by the staff economists to assist active cases. No such positions currently exist in the various field economist locations. In addition, reference materials purchased by the Service have been limited in number and sometimes not kept up to date. Statistical analyses are hampered by lack of state-of-the-art computer equipment, software, and databases. Report preparation is often hampered by the quality and availability of clerical support. This is due in no small measure to repeated budget cuts and resulting procurement and hiring freezes.

Securing comparable data from public and private sources is also a difficulty in case development. While the regulations seem to imply that finding comparables is relatively easy, it in fact is not. Research materials and reference sources are not always available.

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Securing comparable data from public and private sources is also a difficulty in case development. While the regulations seem to imply that finding comparables is relatively easy, it in fact is not. Research materials and reference sources are not always available.

There are usually only a few third-party companies which may serve as the basis for a comparable to the taxpayer and fewer still which are public. To obtain data from these companies, a summons often must be issued. There has been a reluctance, in some cases, to issue summonses. The summons procedure has often been long and cumbersome and has impeded securing the required data. Data, when obtained on these companies, usually requires adjustments to reflect differences between the taxpayer and the third-party companies.

Training for the economists in recent years has included in an annual seminar where Service and outside lecturers have discussed topics of interest, an occasional outside seminar for a few economists, and instruction in the use of the portable computers which were supplied to the examiners and economists. Unfortunately, several of the annual seminars were canceled due to lack of funds. Other than at the few annual seminars which were held, there appears to be little communication between economists of the various field groups. This limits the sharing of ideas and data.

Economic theory plays only a general role in solving the problems faced by the IRS economist. The job is investigative and analytical in nature and often requires innovative solutions. The questions lie in the facts and circumstances of the taxpayer's related transactions and the answers are found in third-party companies dealing at arm's-length. Economic theory may assist in the analysis of these problems. Regardless of the method utilized under section 482—comparable uncontrolled price, resale price, cost plus, or even a fourth method—you must have comparable data from the real world resulting from transactions between unrelated companies.

Experience of economists within the IRS varies considerably. I feel that the level of expertise between the top IRS economists and outside experts is comparable. Some outside experts who have testified in tax cases obtained their credentials for theoretical work and not practical work. Some consulting economists hired by the Service had to be educated with regard to section 482 and that we deal with corporate split personalities. Experts hired by the taxpayers have the advantage of full cooperation by the taxpayer, the availability of all the taxpayer's resources, and the explanation of the transactions in question. The IRS economists would still be waiting for responses to the information requests trying to understand the taxpayer's operations. The outside economic experts all have greater resources than the IRS economists, including junior economists to assist them with the case development, top-notch typists and production people, quality computers and software, and better access to information and databases.

Thank you.

[The prepared statement follows:]

STATEMENT OF

STEVEN M. ZEMSKY

OVERSIGHT SUBCOMMITTEE

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

I currently work as an Economist in the Washington office of the Baltimore District of the Internal Revenue Service. Since December, 1970, when I was hired by the Service, I have provided assistance to Examiners, Appeals Officers, Counsel and Competent Authority within the Service, as well as to the Treasury Department and the Justice Department. My work has focused on intercompany pricing issues involving U.S. taxpayers with controlled foreign corporations, U.S. subsidiaries of foreign-owned companies, and U.S. taxpayers with domestic subsidiaries operating in the U.S. possessions of Puerto Rico and American Samoa. Industries involved in these cases include oil, shipping, electrical products, electronic components, consumer electronic products, canned food, and apparel.

IRS economists have functioned as an in-house consulting group since 1963 to supplement, through economics, the legal and accounting skills of other Service personnel. The creation of a group of economists within the IRS had been recommended by the Treasury Department to improve the analysis of issues and development of cases. The work has included intercompany pricing as well as other issues, such as intangible asset valuations. The small group of economists, which numbered from four to ten people, were located in the National Office of IRS in Washington and provided assistance throughout the country. In 1979, the Economic Assistance program was expanded by adding economists in field locations, including New York, Chicago, San Francisco, Los Angeles and Houston. The economists have always been a "free resource"; that is, their time was not charged to the case on which they were working. This is expected to change in the near future. Earlier in the program, requests for assistance originated on an exception basis in cases of potentially significant deficiencies or of precedent setting issues. Increasingly, with mandatory referral of cases, requests have been repetitive for examinations of the same taxpayers and issues, with a resulting strain on the limited economist manpower.

The chronology of an economist's participation in a case under examination is as follows: after receiving a request for economic assistance, a determination is made as to whether an economist will participate. A meeting is held with the examination team assigned to the case to determine if the issue in the request is economic in content and is properly characterized and if other economic issues exist. The International Examiner on that team is the primary interface for the economist. Financial and operational information previously obtained by the International Examiner is reviewed by the economist. At one time such information, in general, was fully developed prior to the economist's involvement. Increasingly, it is done after his participation has begun and by him. Additional information and document requests are submitted to the taxpayer.

Subsequent meetings, including several with the taxpayer and his operating personnel, will be held to determine the taxpayer's and related company functions and operations. Visitations to taxpayer locations other than the corporate offices, including foreign trips, are often necessary to fully understand the taxpayer's operations. The economist develops an approach to the issue; researches public information; identifies comparables from taxpayer supplied information, as well as public and private sources; and, with the International Examiner, quantifies any appropriate adjustment. If an adjustment is warranted, the economist will prepare a report supporting that adjustment. The difficulties encountered by the economist while participating in examinations fall primarily in two areas; those caused by the taxpayer and those caused by the Service. Taxpayers often delay in responding to requests for information. These delays sometimes put time pressure on the closing of the case and may limit the time available for research on the issue and preparation of reports. Taxpayers sometimes claim that requested information either is no longer available or never existed. Additionally, foreign-owned taxpayers will usually claim that information requested concerning the parent or other related company with whom they have transactions is unavailable. This lack of information may prevent the economist from gaining a clear understanding of the taxpayer's operations and hamper the focus of his research. When taxpayers, or their related companies, have supplied data on comparability for the transactions in question, it usually has been for differentiated products and/or at the wrong level of market. The Service provides the economist with little or no resource support. For instance, while the unit was in the National Office, an economic research assistant aided the economists in securing information from public sources and preparing statistical analyses directed by the economists. Also, graduate economics students served as summer interns and were assigned research projects by the staff economists to assist active cases. No such positions currently exist in the various field economist locations. In addition, reference materials purchased by the Service have been limited in number and sometimes not kept up to date. Statistical analyses are hampered by lack of state-of-the-art computer equipment, software, and data bases. Report preparation is often hampered by the quality and availability of clerical support. This is due in no small measure to repeated budget cuts and resulting procurement and hiring freezes.

Securing comparable data from public and private sources is also a difficulty in case development. While the Regulations seem to imply that finding comparables is relatively easy, it in fact is not. Research materials and reference sources are not always available. There are usually only a few third-party companies which may serve as the basis for a comparable to the taxpayer and fewer still which are public. To obtain data from these companies, a summons often must be issued. There has been a reluctance, in some cases, to issue summonses. The summons procedure has often been long and cumbersome and has impeded securing the required data. Data, when obtained on these companies, usually requires adjustments to reflect differences between the taxpayer and the third-party companies.

Training for the economists in recent years has been included an annual seminar where Service and outside lecturers have discussed topics of interest, an occasional outside seminar for a few economists, and instruction in the use of the portable computers which were supplied to the examiners and economists. Unfortunately, several of the annual seminars were canceled due lack of funds. Other than at the few annual seminars which were held, there appears to be little communication between economists of the various field groups. This limits the sharing of ideas and data.

Economic theory plays only a general role in solving the problems faced by the IRS economist. The job is investigative and analytical in nature and often requires innovative solutions. The questions lie in the facts and circumstances of the taxpayer's related transactions and the answers are found in third-party companies dealing at arm's length. Economic theory may assist in the analysis of these problems. Regardless of the method utilized under Section 482 (Comparable Uncontrolled Price, Resale Price, Cost Plus, or even a fourth method), you must have comparable data from the real world resulting from transactions between unrelated companies. Experience of economists within the IRS varies considerably. I feel that the level of expertise between the top IRS economists and outside experts is comparable. Some outside experts who have testified in tax cases obtained their credentials for theoretical work and not practical work. Some consulting economists hired by the Service had to be educated with regard to Section 482 and that we deal with corporate split personalities. Experts hired by the taxpayers have the advantage of full cooperation by the taxpayer, the availability of all the taxpayer's resources, and the explanation of the transactions in question. The IRS economist would still be waiting for responses to the information requests trying to understand the taxpayer's operations. The outside economic experts all have greater resources than the IRS economists, including junior economists to assist them with case development, top-notch typists and production people, quality computers and software, and better access to information and data bases.

STATEMENT OF EDWARD ROMOFF, INTERNATIONAL GROUP MANAGER, INTERNAL REVENUE SERVICE, LOS ANGELES, CALIF.

Mr. ROMOFF. I am a certified public accountant licensed in the State of California. I have been employed by the Internal Revenue Service for the past 28 years. I have been a manager since 1971. From 1974 to 1985, I was an international group manager in the Los Angeles district. From 1985 to 1988, I was Chief of the International Enforcement Division under the Assistant Commissioner—International, Washington, D.C. In 1988, I completed my assignment to the national office and returned to my current position as international group manager in Los Angeles. I have more than 16 years experience in the international enforcement area.

I have been analyzing the foreign-owned/controlled area since 1974. In that year, I began tracking the tax returns of foreign-owned companies to confirm our concern with tax compliance. In 1979, I presented the results of this analysis to IRS national office personnel. At that time, the Internal Revenue Service had a bulldog theory and was not enthusiastic about pursuing these type of examinations. The theory was that if tax was paid to a tax treaty country by the taxpayer, the IRS should not attempt to bite the same piece of meat.

In Los Angeles, we had initiated section 482 examinations on the foreign-owned distributor taxpayers. In the late 1970s, two international examiners, Rod Longenberger and Norman Smoller, met with me to discuss the progress of these examinations. My instruction to them was to continue the examinations until they were satisfied that the pricing between the foreign parent manufacturer and the foreign-owned U.S. distributor were at the arms-length standard required by section 482 of the Internal Revenue Code. A number of years later, those two agents recommended about $1 billion in additional tax deficiencies on those cases.

Many events took place during that period that reflect on IRS' effectiveness in the section 482 foreign-owned area. Some of those events had to do with IRS counsel, IRS economists, access to foreign-based records, court proceedings, IRS policies that impeded the development of the issues, protests by a foreign government and cooperation from U.S. comparative companies. Some of the events that occurred during the period which provide an overview are as follows:

First, three different sets of both IRS and non-IRS economists were used

Second, four different sets of IRS counsels were used.

Third, at the initiation of these examinations, the Los Angeles district received less than enthusiastic support from the IRS national office because of the bulldog theory that prevailed at that time.

Fourth, we received constant pressure from various elements in the IRS to close these examinations before they were fully developed.

Fifth, during the course of these examinations in the late seventies and early eighties, there were threats of job loss and examination team transfers if these cases were not closed, even though not fully developed.

Sixth, we received criticism for not fully developing the issues after being forced to close the cases prematurely.

Seventh, an economic theory was developed by an IRS economist that prevailed.

Eighth, a legal theory was developed by an IRS attorney that prevailed.

Ninth, we received excellent cooperation from the U.S. comparable companies.

Tenth, the Government recovered approximately $1 billion in additional tax and interest when these examinations were finally resolved.

Among the many problems associated with administering U.S. tax laws as they apply to foreign-owned companies, is that the nontimely production of requested records from the taxpayer has been a chronic one for the IRS examination teams. This problem is intensified where the taxpayer is a United States or foreign-owned multinational entity subject to section 482, subpart F of the Internal Revenue Code, or claims foreign tax credits on its U.S. tax return. I believe section 982 has been used effectively to get more timely compliance in foreign tax credit areas. New section 6038A should provide incentives to foreign-owned U.S. companies to provide records more timely.

Associated with the problem of untimely production of requested records is the IRS difficulty in determining what an arms-length price should be as opposed to the taxpayers supporting their pricing policies on sound arms-length principles.

For example, when we ask how prices were derived, the answer almost invariably is by negotiation. In a controlled parent-subsidiary setting, there are no true negotiations because the controlled party cannot walk away from the decision table. When the IRS pursues the scenario by requesting minutes and documents of these negotiations, almost always the answer is there are no minutes or documentation and that the negotiations were by oral agreement.

I urge the subcommittee to consider the section 482 white paper recommendations which require the taxpayer to document their pricing policies. Thank you very much.

Mr. **Dorgan**. Thank you very much.

[The prepared statement follows:]

STATEMENT OF

EDWARD ROMOFF

BEFORE THE OVERSIGHT SUBCOMMITTEE

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

MY NAME IS EDWARD ROMOFF. I AM A CERTIFIED PUBLIC ACCOUNTANT LICENSED IN THE STATE OF CALIFORNIA. I HAVE BEEN EMPLOYED BY THE INTERNAL REVENUE SERVICE FOR THE PAST 28 YEARS. I HAVE BEEN A MANAGER SINCE 1971. FROM 1974 TO 1985, I WAS AN INTERNATIONAL GROUP MANAGER IN THE LOS ANGELES DISTRICT. FROM 1985 TO 1988, I WAS CHIEF OF THE INTERNATIONAL ENFORCEMENT DIVISION UNDER THE ASSISTANT COMMISSIONER (INTERNATIONAL), WASHINGTON, D. C. IN 1988, I COMPLETED MY ASSIGNMENT TO THE NATIONAL OFFICE AND RETURNED TO MY CURRENT POSITION AS INTERNATIONAL GROUP MANAGER IN LOS ANGELES. I HAVE MORE THAN 16 YEARS EXPERIENCE IN THE INTERNATIONAL ENFORCEMENT AREA.

I AM HONORED TO TESTIFY BEFORE THE SUBCOMMITTEE IN ITS EFFORTS TO ASSIST THE INTERNAL REVENUE SERVICE TO BE MORE EFFECTIVE IN THE ENFORCEMENT OF SECTION 482 OF THE INTERNAL REVENUE CODE.

I HAVE BEEN ANALYZING THE FOREIGN-OWNED/CONTROLLED AREA SINCE 1974. IN THAT YEAR, I BEGAN TRACKING THE TAX RETURNS OF FOREIGN-OWNED COMPANIES TO CONFIRM OUR CONCERN WITH TAX COMPLIANCE. IN 1979, I PRESENTED THE RESULTS OF THIS ANALYSIS TO IRS NATIONAL OFFICE PERSONNEL. AT THAT TIME, THE INTERNAL REVENUE SERVICE HAD A "BULLDOG THEORY" AND WAS NOT ENTHUSIASTIC ABOUT PURSUING THESE TYPE OF EXAMINATIONS. THE THEORY WAS THAT IF TAX WAS PAID TO A TAX TREATY COUNTRY BY THE TAXPAYER, THE IRS SHOULD NOT ATTEMPT TO "BITE THE SAME PIECE OF MEAT".

IN LOS ANGELES, WE HAD INITIATED THE SECTION 482 EXAMINATIONS ON THE FOREIGN-OWNED AUTOMOBILE DISTRIBUTOR TAXPAYERS. SOMETIME DURING 1978, TWO INTERNATIONAL EXAMINERS MET WITH ME TO DISCUSS THE PROGRESS OF THESE EXAMINATIONS. MY INSTRUCTION TO THEM WAS TO CONTINUE THE EXAMINATIONS UNTIL THEY WERE SATISFIED THAT THE PRICING BETWEEN THE FOREIGN PARENT MANUFACTURER AND THE FOREIGN-OWNED U.S. DISTRIBUTOR WERE AT THE ARMS-LENGTH STANDARD REQUIRED BY SECTION 482 OF THE INTERNAL REVENUE CODE. A NUMBER OF YEARS LATER, THOSE TWO AGENTS RECOMMENDED ABOUT ONE BILLION DOLLARS IN ADDITIONAL TAX DEFICIENCIES ON THOSE CASES.

MANY EVENTS TOOK PLACE DURING THAT PERIOD THAT REFLECT ON IRS' EFFECTIVENESS IN THE SECTION 482 FOREIGN-OWNED AREA. SOME OF THOSE EVENTS HAD TO DO WITH IRS COUNSEL, IRS ECONOMISTS, ACCESS TO FOREIGN-BASED RECORDS, COURT PROCEEDINGS, IRS POLICIES THAT IMPEDED THE DEVELOPMENT OF THE ISSUES, PROTESTS BY A FOREIGN GOVERNMENT AND COOPERATION FROM U.S. COMPARATIVE COMPANIES, ETC. SOME OF THE EVENTS THAT OCCURRED DURING THE PERIOD WHICH PROVIDE AN OVERVIEW ARE AS FOLLOWS:

1. THREE DIFFERENT SETS OF BOTH IRS AND NON-IRS (OUTSIDE CONTRACTOR) ECONOMISTS WERE USED.

2. FOUR DIFFERENT SETS OF IRS COUNSELS WERE USED.

3. AT THE INITIATION OF THESE EXAMINATIONS, THE LOS ANGELES DISTRICT RECEIVED LESS THAN ENTHUSIASTIC SUPPORT FROM THE IRS NATIONAL OFFICE BECAUSE OF THE "BULLDOG THEORY" THAT PREVAILED AT THAT TIME.

4. WE RECEIVED CONSTANT PRESSURE FROM VARIOUS ELEMENTS IN THE IRS TO CLOSE THESE EXAMINATIONS BEFORE THEY WERE FULLY DEVELOPED.

5. THERE WERE THREATS OF JOB LOSS AND EXAMINATION TEAM TRANSFERS IF THESE CASES WERE NOT CLOSED, EVEN THOUGH NOT FULLY DEVELOPED.

6. WE RECEIVED CRITICISM FOR NOT FULLY DEVELOPING THE ISSUES AFTER BEING FORCED TO CLOSE THE CASES PREMATURELY.

7. A COURT DECISION WAS SOUGHT CONCERNING THE GOVERNMENT'S RIGHT TO FOREIGN-BASED RECORDS DEEMED RELEVANT TO A SECTION 482 DETERMINATION.

8. AN ECONOMIC THEORY WAS DEVELOPED BY AN IRS ECONOMIST THAT PREVAILED.

9. A LEGAL THEORY WAS DEVELOPED BY AN IRS ATTORNEY THAT PREVAILED.

10. WE RECEIVED EXCELLENT COOPERATION FROM THE U.S. COMPARABLE COMPANIES.

11. THE GOVERNMENT RECOVERED APPROXIMATELY ONE BILLION DOLLARS IN ADDITIONAL TAX AND INTEREST WHEN THESE UNAGREED EXAMINATIONS WERE FINALLY SETTLED.

IF THE SUBCOMMITTEE DESIRES, I WILL BE HONORED TO ELABORATE ON ANY OR ALL OF THE ABOVE.

AMONG THE MANY PROBLEMS ASSOCIATED WITH ADMINISTERING U.S. TAX LAWS AS THEY APPLY TO FOREIGN-OWNED COMPANIES, IS THAT THE TIMELY PRODUCTION OF REQUESTED RECORDS FROM THE TAXPAYER HAS BEEN A CHRONIC ONE FOR THE IRS EXAMINATION TEAMS. THIS PROBLEM IS INTENSIFIED WHERE THE TAXPAYER IS A U.S. OR FOREIGN-OWNED MULTI-NATIONAL ENTITY SUBJECT TO SECTION 482, SUBPART F OF THE INTERNAL REVENUE CODE, OR CLAIMS FOREIGN TAX CREDITS ON ITS U.S. TAX RETURN. I BELIEVE SECTION 982 HAS BEEN USED EFFECTIVELY TO GET MORE TIMELY COMPLIANCE IN FOREIGN TAX CREDIT AREAS. NEW SECTION 6038A SHOULD PROVIDE INCENTIVES TO FOREIGN-OWNED U.S. COMPANIES TO PROVIDE RECORDS MORE TIMELY.

ASSOCIATED WITH THE PROBLEM OF UNTIMELY PRODUCTION OF REQUESTED RECORDS IS THE IRS DIFFICULTY IN DETERMINING WHAT AN ARMS-LENGTH PRICE SHOULD BE AS OPPOSED TO THE TAXPAYERS SUPPORTING THEIR PRICING POLICIES ON SOUND ARMS-LENGTH PRINCIPLES. FOR EXAMPLE, WHEN WE ASK HOW PRICES WERE DERIVED, THE ANSWER ALMOST INVARIABLY IS - BY NEGOTIATION. IN A CONTROLLED "PARENT-SUBSIDIARY" SETTING, THERE ARE NO TRUE NEGOTIATIONS BECAUSE THE CONTROLLED PARTY CANNOT WALK AWAY FROM THE DECISION TABLE. WHEN THE IRS PURSUES THE SCENARIO BY REQUESTING MINUTES AND DOCUMENTS OF THESE NEGOTIATIONS, ALMOST ALWAYS THE ANSWER IS - THERE ARE NO MINUTES OR DOCUMENTATION AND THAT THE NEGOTIATIONS WERE BY ORAL AGREEMENT. I URGE THE SUBCOMMITTEE TO CONSIDER THE "SECTION 482 WHITE PAPER" RECOMMENDATIONS WHICH REQUIRE THE TAXPAYER TO DOCUMENT PRICING POLICIES.

ANOTHER AREA OF CONCERN IS THE IRS LACK OF COMPLETELY UNDERSTANDING THE DIFFERENCES IN BUSINESS CULTURES OF THE FOREIGN PARENT COUNTRIES AS THEY IMPACT THEIR SUBSIDIARIES DOING BUSINESS IN THE UNITED STATES. FOR EXAMPLE, "CONTROL" MAY NOT NECESSARILY EXIST THROUGH STOCK OWNERSHIP BUT RATHER THROUGH ECONOMIC FAMILIES OF LONG-STANDING. WE MAY BE UNAWARE OF A BUSINESS DECISION, MADE IN THE FOREIGN COUNTRY, AFFECTING THE OPERATIONS OF A U.S. SUBSIDIARY, BECAUSE OF OUR LACK OF KNOWLEDGE OF BUSINESS PRACTICES IN THAT COUNTRY. I BELIEVE THE IRS NEEDS TO

EXAMINE MORE OF THESE CORPORATIONS TO GAIN MORE KNOWLEDGE AND BECOME MORE EFFECTIVE IN DETERMINING THEIR COMPLIANCE WITH SECTION 482.

MY ASSESSMENT OF THE IRS INTERNATIONAL ENFORCEMENT PROGRAM IS THAT IT HAS COME A LONG WAY SINCE 1974. THE NUMBER OF INTERNATIONAL EXAMINERS HAS INCREASED TO OVER 500 NATIONWIDE FROM APPROXIMATELY 100 IN 1974. THE FORMATION OF THE ASSOCIATE CHIEF COUNSEL (INTERNATIONAL) HAS BEEN THE MOST SIGNIFICANT IMPROVEMENT IN THE PAST FIVE YEARS; THEY HAVE PROVIDED DIRECT AND TECHNICAL ASSISTANCE TO THE FIELD. HOWEVER, IT IS MY IMPRESSION THAT THERE IS STILL LESS THAN TOTAL COMMITMENT TO FOREIGN-OWNED CORPORATION NON-COMPLIANCE CONCERNS BY VARIOUS ELEMENTS IN THE INTERNAL REVENUE SERVICE.

IF THE INTERNAL REVENUE SERVICE IS TO BECOME TRULY EFFICIENT IN THE INTERNATIONAL ENFORCEMENT PROGRAM AREA, IT MUST DO MORE TO PROMOTE AND SUPPORT THE PROFESSIONALISM AND INNOVATION OF ITS EMPLOYEES.

THERE ARE CONSIDERABLE SHORTAGES IN BOTH STAFFING AND EXPERIENCE OF LOCAL IRS ATTORNEYS AND ECONOMISTS. THESE TWO DISCIPLINES ARE EXTREMELY CRITICAL TO THE SUCCESSFUL DEVELOPMENT OF A SECTION 482 ISSUE.

IN LOS ANGELES, WE ARE WORKING WITH THE SEVENTH DISTRICT COUNSEL ATTORNEY IN TWO YEARS. CONTINUITY ON MANY EXAMINATIONS HAS BEEN HAMPERED AS A RESULT OF LOSS OF IRS INTERNATIONAL ATTORNEYS THROUGH RESIGNATIONS AND TRANSFERS TO OTHER AGENCIES.

IN SOUTHERN CALIFORNIA, WHERE THERE ARE THOUSANDS OF CORPORATIONS WITH INTERNATIONAL TRANSACTIONS, THE IRS HAS ONLY FIVE ECONOMISTS TO ASSIST THE INTERNATIONAL EXAMINERS. HOWEVER, WE RECENTLY RECEIVED AUTHORIZATION TO HIRE FOUR MORE, WHICH IS STILL WOEFULLY SHORT OF OUR NEEDS. WE NEED A STRONG NATIONAL COMMITMENT TO THE ECONOMIC ASSISTANCE PROGRAM.

LASTLY, THE PAY-SCALE GAPS, PARTICULARLY IN CITIES LIKE LOS ANGELES, ARE NEGATIVELY AFFECTING OUR ABILITY TO RECRUIT AND RETAIN GOOD EMPLOYEES. COMPENSATION FOR REVENUE AGENTS IS LAGGING BY A 40% COMPARABILITY IN ALMOST ALL CATEGORIES. IRS ATTORNEYS COMPENSATION IS LAGGING BY MORE THAN 65%. THERE ARE CURRENT REPORTS AVAILABLE TO THE SUBCOMMITTEE THAT DEMONSTRATE HOW MUCH THAT COMPARABILITY GAP HAS INCREASED OVER THE PAST SEVERAL YEARS. THIS CONCLUDES MY TESTIMONY. I THANK YOU AGAIN FOR THE OPPORTUNITY TO SPEAK BEFORE YOUR SUBCOMMITTEE.

Mr. DORGAN. Ms. Lewin.

STATEMENT OF PAMELA A. LEWIN, CASE MANAGER, INTERNAL REVENUE SERVICE, LAGUNA NIGUEL, CALIF.

Ms. LEWIN. I am a certified public account, licensed in the State of California. I have been with the IRS for 24 years, including approximately 15 years in various management positions. Currently, I am assigned to the Carson post-of-duty in the Laguna Niguel district.

My experience in regard to section 482 involves inbound pricing issues in the area of electronic and motor vehicle products. I am currently the case manager for four audits involving importers of consumer electronic products and five audits involving importers of motor vehicle products all from Pacific rim countries.

Recently two separate taxpayers paid deficiencies in regard to their fiscal years ending in 1979 through 1984. In both of these cases, the resale price method under section 482 was used to compute the amount of the adjustment. This method compares the gross profit margin of the taxpayer with the weighted average of the gross profit margins of uncontrolled U.S. importers of motor vehicles after making adjustments to put all entities on the same footing—for example, warranty expense, rebates and interest expense.

It should be noted that, at the Examination Division level, any overpayment to the foreign parent for the motor vehicles is considered to be a dividend subject to withholding tax under IRC section 1441.

Skipping to examples of how taxpayers are able to avoid paying income taxes, the bottom of page 1, the primary method of how taxpayers are able to avoid paying U.S. income taxes is to pay a higher price to the foreign parent for the imported goods.

This results in the income being reported in the foreign country with a corresponding decrease in the taxable income being reported in the United States.

Normally, a corporation would distribute its profits to its shareholders who would in turn report dividend income. If the shareholder is a foreign entity, the distribution would be subject to a withholding tax. By overpaying for the goods initially, a transfer of funds is received by the parent without paying the required withholding tax.

The problems experienced by case managers. The hierarchy of methodology mandated in the section 482 regulations creates difficulties in sustaining a pricing adjustment. For example, the comparable uncontrolled price method (CUP) is the first required method and the resale price method is the second.

If the taxpayer pays the same or a higher price for the vehicles under the CUP method as the uncontrolled purchaser of the nearly identical product, then no issue is supposed to be present.

When there is no uncontrolled purchaser of a nearly identical product, then if the taxpayer reports a higher gross markup than the uncontrolled comparable entities report for a similar product, no adjustment would result under the resale price method.

A particular problem is that some of the foreign-owned taxpayers are incurring high sales and general and administrative expenses. These expenses are commonly referred to as below-the-line expenses and do not affect the gross markup in its usual definition.

The obvious problem is that although the taxpayer's gross markup is higher than the comparable uncontrolled taxpayers, the taxable income reported is either minimal or a loss.

For example, one electronics company which has relatively high gross markup has reported losses for 7 years in a row. This taxpayer's budgets even reflect that a loss is projected.

An uncontrolled distributor would have negotiated a better price in order to cover expenses or discontinued purchasing the items. In other words, an uncontrolled distributor would not have continued in business over this period of time when no profit or return on assets could be expected.

The answer in my opinion would be to eliminate the hierarchy of required methods under section 482 and allow IRS personnel to develop the best possible method to sustain the issue. It should be noted that the comparable tax law recently instituted in Japan does not mandate the order of methods for proposing a pricing adjustment.

Another problem is in the area of setoffs allowed by the section 482 regulations. For example, assume under the resale price method that a foreign-owned taxpayer has a higher gross profit margin than the comparables for its motor vehicle products, but a lower gross profit margin than the comparables for another product line.

Should a setoff be allowed against the adjustment on the other product line for the higher gross profit margin reported on the motor vehicles? Keep in mind that the higher profit reported on the motor vehicles may be the correct amount or even still too low for the taxpayer's U.S. operations.

One other problem is the lack of knowledge of foreign tax laws by IRS personnel. In the prior example of the taxpayer who reported large net operating losses for 7 years, it was wondered why the foreign parent did not lower the prices of the goods charged to its wholly-owned U.S. subsidiary instead of constantly purchasing additional newly issued stock, apparently as a means of funding the subsidiary's losing operation.

It was learned from one of your committee reports that in the foreign country involved, taxpayers are allowed to deduct this investment and then, 5 years later, to amortize this amount back into income over an extended period of time. This helps support a position that there has been shifting of income to the parent.

Why else would further investment be made in an entity that continuously reflected no profit and losses are even budgeted for the future.

Thank you.

[The prepared statement follows:]

STATEMENT OF

PAMELA A. LEWIN

BEFORE THE

OVERSIGHT SUBCOMMITTEE

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

Introduction:

Mr. Chairman and Members of the Subcommittee, I am a Certified Public Accountant licensed in the State of California. I have been with the Internal Revenue Service for 24 years including approximately 15 years in various management positions. Currently, I am assigned to the Carson post-of-duty in the Laguna Niguel District.

My experience in regard to section 482 involves in-bound pricing issues in the area of electronic and motor vehicle products. I am currently the Case Manager for four audits involving importers of consumer electronic products from the Pacific Rim and five audits involving importers of motor vehicle products from the Pacific Rim.

Overview of Automobile Distributor Cases

Recently two separate taxpayers paid deficiencies in regard to their fiscal years ending in 1979 through 1984. In both of these cases, the Resale Price Method under section 482 was used to compute the amount of the adjustment. This method compares the gross profit margin of the taxpayer with a weighted average of the gross profit margins of uncontrolled U.S.importers of motor vehicles after making adjustments to put all entities on the same footing (i.e. warranty expense, rebates and interest expense). It should be noted that, at the Examination Division level, any overpayment to the foreign parent for the motor vehicles is considered to be a dividend subject to the 10% Withholding Tax under Internal Revenue Code section 1441.

Subsequently, another audit cycle was closed by the Examination Division on one of these taxpayers resulting in a no change of the Pricing Issue. The other taxpayer is in the final audit stages and should be closed with a substantial deficiency during this quarter.

In addition, four years with respect to third case are in the process of being closed to Appeals this month with large deficiencies resulting from the pricing issue. Three years with respect to a fourth Pacific Rim motor vehicle importer have also been previously closed as a no change under the Comparable Uncontrolled Price Method of the regulations under Section 482.

Finally, a fifth case involving the importation of motor vehicles from the Pacific River is in the initial stages of audit.

Examples of How Taxpayers are Able to Avoid Paying U.S. Income Taxes

The primary method noted on how taxpayers are able to avoid paying U.S. Income Taxes is to pay a higher price to the foreign parent for the imported goods. This results in the income being reported in the foreign country with a corresponding decrease in the taxable income being reported in the United States.

Normally, a corporation would distribute its profits to its shareholders in turn who would report dividend income. If the shareholder is a foreign entity, the distribution would be subject to a withholding tax. By overpaying for the goods initially, a transfer of funds is received by the parent without paying the required withholding tax.

The Problems Experienced by Case Managers

The hierarchy of methodology mandated in the section 482 regulations creates difficulties in sustaining a pricing adjustment. For example, the Comparable Uncontrolled Method (CUP) is the first required method and the Resale Price Method is the second. If the taxpayer pays the same or a higher price for the vehicles under the CUP Method as the uncontrolled purchaser of the nearly identical product, then no issue is supposed to be present. When there is no uncontrolled purchaser of a nearly identical product, then if the taxpayer reports a higher gross mark-up than the uncontrolled comparable entities do for a similar product, no adjustment would result under the Resale Price Method.

A particular problem is that some of the foreign owned taxpayers are incurring high sales and general and administrative expenses. These expenses are commonly referred to as "below the line" expenses and do not affect the gross profit margin in its usual definition. The obvious problem is that although the taxpayer's gross profit is higher than the comparable uncontrolled taxpayers, the taxable income reported is either minor or a loss.

For example, one electronics company which has relatively high gross profit margins, has reported losses for seven years in a row. This taxpayer's budgets even reflect that a loss is projected. In other words, a uncontrolled distributor would have negotiated a better price in order to cover expenses or discontinued purchasing the items. An uncontrolled distributor would not have continued in business over this period of time when no profit or return on assets can be achieved.

The answer in my opinion would be to eliminate the hierarchy of required methods under section 482 and allow IRS personnel to develop the best possible method to sustain the issue. It should be noted the comparable tax law recently instituted in Japan does not mandate the order of methods for proposing a Pricing Adjustment.

Another problem is in the area of setoffs allowed by the Section 482 regulations. For example, assume under the Resale Price Method that a foreign-owned taxpayer has a higher gross profit margin than the comparables for its motor vehicle products, but a lower gross profit margin than the comparables for another product line. Should a setoff be allowed against the adjustment on the for the higher gross margin reported on the motor vehicles? Keep in mind that the higher profit reported on the motor vehicles may be the correct amount or even still too low for the taxpayer's U.S. operations.

One other problem is the lack of knowledge of foreign tax laws by the IRS' personnel. In the prior example of the taxpayer who reported large net operating losses for seven years, it was wondered why the foreign parent did not lower the prices of the goods charged to its wholly owned U. S. subsidiary instead of constantly purchasing additional newly issued stock, apparently as a means of funding the subsidiaries' losing operation. It was learned by chance from one of your Committee Reports that in the foreign country involved, taxpayers are allowed to deduct this investment and then, five years later, to amortize this amount back into income over an extended period of time. This helps support a position that there has been shifting of income to the parent. Why else would further investment be made in an entity that continuously reflected no profit and losses are even budgeted for the future.

The Role of IRS Attorneys in the Examination Process

The IRS attorney's role in the examination process should be to advise the audit team and the Case Manager regarding technical issues and the appropriate documentation necessary if the case goes to trial. In addition, the attorney's role should be to support the audit team in many administrative areas, such as summons enforcement.

An Assessment of the IRS' International Enforcement Program

The International Examiners through the years have done an excellent job with limited information and a very small workforce. The best example of this is the large deficiencies collected on the two auto cases due to the pricing issue as previously discussed.

These two cases were closed agreed by the U.S. Competent Authority after discussions with the other country's Competent Authority. It would be helpful to know what the Competent Authority relied upon to determine the final adjustment. For example, two of the years with large deficiencies on one of the taxpayers was closed by Competent Authority at no change (conceded in full). If this was due to a profit split, it would be helpful to know how this was done.

A problem for the International Examiners is that information obtained from the foreign parent cannot be verified as to correctness. For example, if information from the parent reflected that it had little or no profit on sales to its U. S. subsidiary, these figures cannot be audited to ensure costs applicable to sales other than to the U.S. have not been included in order to mask the parent's excessive profits while the U.S. subsidiary reports a loss.

Mr. Chairman and members of the Subcommittee, I thank you for the opportunity to speak to you today on this very important subject.

Chairman Pickle. Thank you.
Mr. Lowry.

STATEMENT OF DAVID A. LOWRY, INTERNATIONAL EXAMINER, INTERNAL REVENUE SERVICE, FORT LAUDERDALE, FLA.

Mr. Lowry. I have been in the international enforcement program since 1974 and have extensive involvement in taxpayers having inbound and outbound pricing transactions.

For several years during this period I was assigned to the United Nations as a consultant to their transnational corporate division and participated in joint conferences in international pricing matters held in several Far Eastern countries. The committee asked me to provide information on four different topics.

An overview of noncompliance by foreign automotive distributors, specific examples of how these distributors are able to avoid paying U.S. taxes, the problems encountered in developing section

482 cases, and how related auto cases have been coordinated between IRS regions.

As a general overview; my participation in the examination of foreign automobile manufacturers is limited to the Japanese manufacturers which have controlled U.S. importers/distributors.

The degree of tax avoidance by their controlled U.S. importers has varied during this period, depending upon the internal management decisions made within the foreign entities.

Information received during the examinations indicates the intent of the Japanese entities was to remove profits from the United States for several reasons, one of which was to recover losses incurred in other foreign countries.

The import price paid by the U.S. controlled entities consists of five elements, FOB, ocean freight, marine insurance, exchange rates and finance charges. The Japanese entities use all five elements to increase the import prices paid by the U.S.-controlled entities.

Japanese manufacturers have sold similar and/or identical vehicles to unrelated U.S. manufacturers/distributors at substantially lower prices than the prices charged their controlled U.S. entities.

The unrelated U.S. importers purchase and ship the Japanese manufactured vehicles under executed binding long-term contracts and/or agreements. The related Japanese entities transact business without any form of purchase or pricing contracts.

Prices paid by the controlled U.S. importer/distributors are changed, usually on a monthly basis, at the discretion of the the Japanese manufacturers and/or trading entities. The only known contracts executed between the Japanese entities and the controlled U.S. importers were distribution agreements which contained no pricing clauses.

The following are only a few examples of methods used by the Japanese entities to remove profits from the United States.

Overpricing of vehicles to the controlled U.S. importers. Identical vehicles sold in the Japanese home market at cash retail prices are priced from $500 to $2,000 less than the FOB export price to the United States. The FOB prices for identical vehicles to the Puerto Rico market were approximately $800 lower than the FOB prices to the controlled U.S. importers.

Identical Japanese trucks were sold to an unrelated U.S. manufacturer/importer at substantially lower prices than prices charged their controlled U.S. importers. Similar vehicles are sold to all of the unrelated U.S. auto manufacturers at prices which allow them to earn gross profits that generally range from 15 to 20 percent. The controlled U.S. entities are usually limited to a range of 3 to 8 percent.

The lower gross profit percentages occur because the manufacturer sets and dictates the dealer wholesale and the import prices for the controlled entities. In some cases the controlled U.S. importers were forced to sell the vehicles at a loss.

I would like to turn the general problems we have had in developing section 482 cases.

Consistent major problems are the failure of the foreign controlled U.S. importers and foreign entities to provide requested documentation located within and without the United States on a timely basis or a complete failure to furnish any of the requested information. The usual explanation given is that the documents are not maintained by or available to the U.S. importers.

In some instances, documents that are furnished are in foreign languages and translations provided by the taxpayer have later been found to be incorrect. Because the Service does not have in-house translators readily available, it is required to expend an inordinate amount of resources to obtain valid translations.

Additionally, it is very difficult to identify and secure the services of qualified independent translators.

The Service is aware of the problems dealing with the production and translation of documents and is currently drafting regulations for code section 6038A. Coordination of section 482 issues for automobile cases are made between IRS regions. In cases where we have coordinated, we have done so between the Eastern and Western parts of the United States, we have held joint meetings to determine the information and documents needed for the issuance of summons.

We have had planning and strategy meetings with telephone conversations, and joint meetings have been held in Washington and Florida to determine any differences encountered between the regions. Examination activities and strategies are coordinated on a regular basis via correspondence, telephone, et cetera.

Joint examination planning meetings are held to determine the degree of assistance needed in the event that the cases are tried or forwarded to competent authority.

The Southwest and Western regions have obtained the assistance of IRS's economists and the services of translations and appraisal firms. Assistance is also obtained during the developmental stages from district and regional IRS counsel and have been expanded to include attorneys from associate chief counsel international.

I thank you.

[The prepared statement follows:]

STATEMENT OF

DAVID A. LOWRY

BEFORE THE

OVERSIGHT SUBCOMMITTEE

HOUSE WAYS AND MEANS COMMITTEE

JULY 10, 1990

This statement is prepared in accordance with the letter dated June 7, 1990 from Congressman J.J. Pickle, Chairman, Subcommittee on Oversight to Mr. Fred T. Goldberg, Jr., Commissioner, Internal Revenue Service, regarding the subcommittee hearings on tax underpayments by U.S. subsidiaries of foreign owned companies and other compliance issues.

My name is Mr. David A. Lowry. I am an International Examiner residing in Jacksonville, Florida and assigned to the Ft. Lauderdale District. I have been in the Examination Division International Enforcement Program since October 1974 and have had extensive involvement in examining taxpayers having both Inbound and Outbound pricing transactions. For several years during this period I was assigned to the United Nations as a consultant to their Transnational Corporate Division and participated in joint conferences on international pricing held in several Far Eastern countries. The topics and information contained herein pertain only to the subject matter requested from me. I was requested to provide information on the following:

I. An overview of noncompliance by foreign automobile distributors.

II. Specific examples of how these distributors are able to avoid paying U.S. tax.

III. The problems encountered in developing Section 482 cases.

IV. How automobile cases which may be related are coordinated among the various IRS regional offices.

I. Overview - Noncompliance by Foreign Automobile Distributors

My participation in examinations of Foreign Automobile manufacturers is limited to the Japanese manufacturers which have controlled U.S. importers/distributors. Noncompliance with the U.S. tax laws by the entities involved with the importation of Japanese manufactured vehicles has been evident for several years. The degree of tax avoidance by their controlled U.S. importers has varied during this period, depending upon the internal management decisions made within the foreign entities. Information received during the examinations indicates the intent of the Japanese entities was to remove profits from the United States for several reasons, one of which was to recover losses incurred in other foreign countries.

The import price paid by the U.S. controlled entities consists of five elements, FOB (Export Price), Ocean Freight, Marine Insurance, Exchange Rates and Finance Charges. The Japanese entities use all five elements to increase the import prices paid by the U.S. controlled entities. The Japanese manufacturer can dictate and control the suggested retail, dealer wholesale and import prices, even though it directly owns 50% or less of the U.S. entities stock.

Japanese manufacturers have sold similar and/or identical vehicles to unrelated U.S. manufacturers/distributors at substantially lower prices than the prices charged their controlled U.S. entities.

The unrelated U.S. importers purchase and ship Japanese manufactured vehicles under executed binding long-term contracts and/or agreements. The related Japanese entities transact business without any form of purchase or pricing contracts. Prices paid by the controlled U.S. importers/distributors are changed, usually on a monthly basis, at the discretion of the Japanese manufacturers and/or trading entities. The only known contracts executed between the Japanese entities and the controlled U.S. importers were distribution agreements which contained no pricing provisions.

II. Specific Examples - How Importers/Distributors Avoided U.S. Tax

Following are some examples of methods used by the Japanese entities to remove profits from the United States.

1. Overpricing of vehicles to the controlled U.S. importers

Identical vehicles sold in the Japanese home market at Cash Retail Prices are priced from $500 to $2,000 less than the FOB Export Prices to the United States. The FOB prices for identical vehicles to the Puerto Rico market were approximately $800 lower than the FOB prices to the controlled U.S. importers.

Also, identical Japanese trucks were sold to an unrelated U.S. manufacturer/importer at substantially lower prices than prices charged their controlled U.S. importers. Similar vehicles are sold to all of the unrelated U.S. auto manufacturers at prices which allow them to earn gross profits that generally range from 15 to 20 percent. The controlled U.S. importers gross profits are usually limited to a range of 3 to 8 percent. The lower gross profit percentages occur because the manufacturer sets and dictates the dealer wholesale and the import prices for the controlled entities. In some cases the controlled U.S. importers were forced to sell the vehicles at a loss.

2. Overcharging for Ocean Freight

Higher prices were charged to the controlled U.S. importers for ocean freight on vehicles delivered on the same day, by the same ship and to the same port as vehicles delivered to unrelated entities.

3. Overcharging for Financing of Shipments

Accounts receivable are collected in advance by the Japanese trading entities from Japanese banks. The Japanese manufacturers have normally allowed from 10 to 45 interest free days for payment. In one case independent buyers had 10 days interest free to make payment. The Japanese trading entity was also given 10 days by the same Japanese manufacturer. The controlled U.S. importer was required to pay the interest charged by the Japanese bank for the advance of funds to the trading company even though the payment for the vehicles by the controlled U.S. entity was not required or made until 10 days after export.

4. Overcharging on Currency Exchange

   a. Ocean freight charges are calculated in U.S. Dollars and paid by the Japanese trading company in Yen at the exchange rate on the export date in accordance with the shipping terms. This Yen amount is then reconverted by the trading company on the same day at a different exchange rate, which produces a higher U.S. Dollar charge to be added to the U.S. invoice prices.

   b. Unsupported exchange rates are used to convert the total Yen prices to U.S. Dollars. It was claimed the Japanese trading company was purchasing forward exchange contracts on behalf of the U.S. importer but the exchange rates used do not agree with certified rates that are in effect on the payment dates required by the Japanese manufacturer.

III. Problems Encountered in Developing Section 482 Cases

Consistent major problems are the failure of the foreign controlled U.S. importers and foreign entities to provide requested documentation located within and without the United States on a timely bases or a complete failure to furnish any of the requested information. The usual explanation given is that the documents are not maintained by or available to the U.S. importers.

In some instances, documents that are furnished are in foreign languages and translations provided by the taxpayer have later been found to be incorrect. Because the Service does not have in-house translators readily available, it is required to expend an inordinate amount of resources to obtain valid translations. Additionally, it is very difficult to identify and secure the services of qualified independent translators.

The Service is aware of the problems dealing with the production and translation of foreign documents and is currently drafting regulations for Code Section 6038A which may assist in the resolution of this matter.

Another problem is securing comparable pricing information from third parties who usually have no business transactions with or direct knowledge of the controlled taxpayers affairs. For valid business reasons, third parties are generally reluctant to furnish the necessary information and formal summons must be issued.

The traditional methods used in the U.S. to determine control and whether Section 482 issues exist is based upon percentage of stock ownership. However, a Japanese manufacturer may control all daily business activities of the U.S. importers without the majority of stock ownership. (For reporting purposes, section 6038A was changed in 1989 to use a 25% ownership test.)

Successful discovery and/or examination methods used by one IRS examination district to develop a Section 482 case may be coordinated within a district and between regions on a limited basis, e.g., in related cases. Usually this information is not made readily available nationwide to all International Examiners for use in other types of Section 482 cases.

IV. Coordination of Automobile Case Among IRS Regional Offices

For many years U.S. importers were not examined for Section 482 pricing primarily because the entities reported losses through 1978. With the expansion of audit activity for the 1980 tax years the Southeast and Western Regions began coordinating all examination activities and now participate in the following:

1. Joint planning meetings are held to determine the information and documents needed for the issuance of summons to independent U.S. manufacturers/importers for comparable pricing information to be used in all of the controlled Japanese automobile cases.
2. Planning and strategy meetings plus telephone conferences are held for the issuance of pre-summons letters and/or summons to the U.S. importers, U.S. subsidiaries of the Japanese manufacturer and trading companies, U.S. subsidiaries or branches of Japanese banks involved in finance of exports to the United States and firms used to nationally advertise the Japanese manufactured vehicles.
3. Joint meetings are held in California, Florida and Washington DC to resolve any differences encountered between IRS regions.
4. Examination activities and strategies are coordinated on a regular basis via correspondence, telephone and transmission of computer files generated. Exchange of workpapers, comparison of computations and other factual evidence are made on a regular basis. Meetings are held to resolve any factual information or computational differences before presentation to the taxpayers.
5. Joint examination planning meetings are held to determine the degree of assistance needed in the event the cases are tried and/or forwarded to Competent Authority. The Southeast and Western Regions have obtained the assistance of IRS Economists and Independent Economists and the services of Independent Translation and Appraisal firms. Assistance is also obtained, during the development stages, from District and Regional IRS Counsel and has been expanded to include attorneys from Associate Chief Counsel (International).

Chairman PICKLE. Thank you.

The next person will be Ms. Zuniga.

STATEMENT OF FRANCES ZUNIGA, FORMER INTERNATIONAL EXAMINER, INTERNAL REVENUE SERVICE, LOS ANGELES, CALIF.

Ms. ZUNIGA. Thank you.

Please accept my thanks for the opportunity to speak to you today. I am now employed by the California Franchise Tax Board.

I am involved with training State auditors on section 482 and other Federal sections.

Before I started with the FTB, I was a revenue agent with the IRS for almost 15 years, 6 of those years I was an international examiner (IE). As an IE, I examined foreign-owned distributors of consumer products as well as U.S.-based corporations and their controlled foreign corporations. While with the IRS, I proposed adjustments and issued International Examiner's reports based on several international issues, including subpart F issues and IRC section 482 issues. These reports became the basis for both 30- and 90-day letters issued to taxpayers under my examination.

Today I will talk about my experience with foreign-owned distributors, and my observations of the experience. The details to this are many and cannot be discussed in open session. Based on the examinations of such companies, in appropriate cases we determined that U.S. taxes were not being paid under the arm's-length standard required by section 482.

We made our conclusions after observing the following: Companies lost money. Losses were directly attributable to expenses incurred. The explanations the taxpayers gave us were they felt there was an anticipated decline in their sales.

And the resulting increase in their inventory was due to circumstances beyond their control. They told us they felt they were in a catch-22 dilemma.

While they had overstocked inventory, they still had to bring in new products to attract their dealers. We didn't deny the explanations. However, we felt that if they and the factory overproduced the product, why should Uncle Sam not only pick up the tab for the subsidiary's losses, but of the factory's as well?

We believe the subsidiaries would not have been in this dilemma had they been independent. Therefore, we proposed the 482 adjustment based on a U.S. arm's-length standard defined by our economist.

I am not convinced that income or loss was shifted because of the companies' operations.

I think the planning was probably concocted on the other side of the globe. I am not sure that this problem can really be addressed through new income tax law, but by continued effort to negotiate with the other side such as what happens during competent authority process. The problem is with section 482 and the regulations. Nobody knows what arm's-length means.

This is especially true in situations where there are no comparables. Because we have to depend on a hypothetical situation, the arm's-length standard exists in the world of smoke and mirrors.

It pretends related companies behave as if they are unrelated and assumes that in each marketplace there are willing buyers and sellers.

This assumption doesn't work where the market is controlled and the three specified methods under the regulations do not apply. Under these circumstances, the IRS is left with using any reasonable method to determine the arm's-length price known as the fourth method. There is almost no guidance on this even though we depend on it quite a bit.

The result becomes chaotic. The scenario becomes predictable because there are several ranges to propose adjustment. The IRS takes one extreme position, the company and the attorneys maintain zero.

Because of the chasm between the two positions, it results in a costly process for both sides.

In my view, this guarantees a tax policy which is inconsistent, lacks integrity and does nothing to motivate voluntary compliance. I believe in the tax system. I understand tax law is not fair to everyone all the time. I believe tax law needs to be administered evenly and consistently all the time. I am not sure this happens with section 482.

Earlier Mr. McGrath asked a question regarding if the burden of proof is on the taxpayer, then why does the IRS go through so much trouble? The reason is a requirement the IRS must satisfy—that it may not be arbitrary, capricious or unreasonable.

Because of this requirement IE's gather exhaustive data at considerable time and expense to the IRS and the taxpayer. The success in meeting this requirement translates into—whoever hires the most expensive economist, cannot possibly be arbitrary or capricious and must certainly be reasonable. The exercise becomes even more frustrating to myself as an IE or former IE when the final adjustment results turns out to be the result of a coin toss.

We went through the whole exercise in tying together information. We issued IDR's, summons, we went through the treaty request process and issued 982 letters.

After all the effort we went through, I am not sure it was worth it. The ultimate value of the information is it froze the facts for litigation purposes but it didn't tell me what the arm's-length price should be.

I needed the information because I had to figure out what was going on. I needed the total picture. But the foreign information we received could not be verified because it was located in a foreign country. Accounting standards and tax laws are different. We could find no one to reconcile the differences for us.

At one point we decided that the information the taxpayer ultimately gave us, if it was the worst case scenario, then should we make an adjustment, and the answer was yes. I was lucky in my audit. I had an economist, a good one, who came on board fairly early.

I had a partner full time, which is unusual, and I had an attorney help me with examinations. This is not usual. With the current problems with the IRS attracting qualified people, the situation will become worse. I have had difficulties with management. During the years I conducted my examination and had to stop progress on my own to brief each newcomer. Some of those managers, frankly, were more interested in getting the case closed than in developing the issue.

At one point one manager suggested that I apply an inappropriate adjustment to get an old cycle closed out early. This didn't happen, of course.

I also found that I had to do work at home on my own time using my own equipment because none was available. All this happened in spite of the fact that the case managers handbook requires the commitment of real time and resources to a transfer pricing case.

I hope I have been able to press upon you the dilemma faced by many IE's working in pricing cases.

Thank you.

[The prepared statement follows:]

STATEMENT OF

FRANCES ZUNIGA

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

July 10, 1990

Mr. Chairman, and members of the Subcommittee:

My name is Frances Zuniga. Please accept my thanks for the opportunity to speak to you today. I would like to share my experience with Section 482 pricing cases. I hope you find my observations useful.

I am now employed by the California Franchise Tax Board. I am involved with training state auditors on Section 482 and other Federal sections. Before I started with the FTB, I was a revenue agent with the IRS for almost 15 years, 6 of those years I was an International Examiner (I.E.). As an I.E., I examined foreign owned distributors of consumer products as well as U.S. based corporations and their controlled foreign corporations. While with the IRS, I proposed adjustments and issued International Examiner's reports based on several international issues, including Subpart F issues and IRC Section 482 issues. These reports became the basis for both 30 and 90 day letters issued to taxpayers under my examination.

Today I will talk about my experience with foreign owned distributors, and my observations of the experience. Based on the examinations of such companies, in appropriate cases we determined that U.S. taxes were not being paid under the arm's length standard required by Section 482. We made our conclusions after observing the following:

During the years under examination, some of the companies had little or no taxable income. This was the result of either current losses, or NOL deductions.

For financial statement purposes, the losses were from the companies' continuing operations as opposed to separately disclosed extraordinary events. The companies were able to operate by receiving large cash infusions from the parent corporations or from continued financing from the banks.

The companies appeared to maintain an uneconomic inventory level. However, they continued to buy what could not be expected to sell in a reasonable amount of time. The companies gave heavy discounts, rebates and incentives to get rid of the old inventory. This added to the losses shown on the tax returns.

The companies financed their inventory purchases through short term borrowings or through their parent corporations. However, because the inventory did not sell, some of them had to refinance their borrowings every month. Of all the line items, a major expense was interest which was directly attributable to the product bought from the parent corporations.

Some of the taxpayers provided the following explanations concerning the situations we observed. They felt that the decline of their sales, and the resulting increase in their inventory were due to circumstances beyond their control. The apparent buildup of their inventory was not foreseen by them; they believed they could sell what they had planned. The damage was realized too late in the inventory ordering cycle. They tried to adjust to the situation but still had to bring in new product in order to maintain their market share and attract new customers. For them the situation created a Catch 22 dilemma.

We did not deny the explanations given by some of the taxpayers. However, we felt that because of the controlled relationship among the subsidiaries and the parent corporations, the subsidiaries absorbed an inappropriate share of the risk without receiving adequate compensation. We firmly believed that the situations the subsidiaries were in would not have existed if they were independent. We believed that the U.S. government was subsidizing not only the losses shown by the subsidiaries but also for the foreign parent corporations.

Therefore, we proposed Section 482 adjustments based upon a U.S. arm's length standard defined by our economist. We concluded that income or loss was shifted because of the companies' operations. However, I don't believe the shifting was an intentional act of evading U.S. income tax. The companies operated based upon their regular business philosophy and culture. This problem should not be addressed through new income tax law, but by a continued effort to understand and negotiate with the other side. In many cases, such negotiations ultimately will involve our government and the foreign government through the competent authority process.

At the heart of the problem is Section 482 and the regulations. No one knows what arm's length means. This is especially true because there are simply no comparable transactions for many of these companies. The arm's length standard exists in a world of smoke and mirrors. The arm's length standard pretends that related companies behave as if they are unrelated, and assumes that in each marketplace there are willing buyers and sellers. This assumption clearly does not work where the market is controlled. The three pricing methods specified under the Regulations; the CUP method, the Resale Price method and the Cost Plus method, clearly cannot apply to the foreign controlled distributor.

Therefore, under these circumstances, the IRS is left with using " any reasonable" method to determine the arm's length standard, or price. This is known as the 4th method. The Regulations give almost no guidance on using the 4th method, despite the growing dependence on it. Instead of providing flexibility to the IRS, the result becomes chaotic, again because no one knows or can agree on what exactly is an arm's length standard.

Unfortunately, the scenario becomes predictable. The company and its attorneys take one extreme position, the IRS the other, each side hoping that their positions will gain the advantage. This results in a costly process for both sides. This forces reliance on a theoretical standard which, only by definition, is reasonable based only on itself and not on the facts and circumstances.

This guarantees a tax policy which is inconsistent, lacks integrity, and does nothing to motivate voluntary compliance. One of the reasons I decided to leave the IRS was because of my dilemma with this situation. I believe in the tax system. I understand that tax law is not always "fair" to all taxpayers all the time. But tax laws need to be administered evenly and consistently all the time, and I am not sure this happens with the administration of Section 482.

With respect to the arm's length standard, a requirement the IRS must satisfy is it may not be arbitrary, capricious or unreasonable. Unfortunately, it is this requirement which stops Section 482 from being a true IRS tool. It is because of this requirement that international examiners must gather exhaustive data at considerable time and expense to both IRS and the taxpayer. The success in meeting this requirement translates into whoever gathers the most information (relevant or not), and whoever hires the most expensive economist, cannot possibly be arbitrary or capricious, and must certainly be reasonable. This exercise becomes even more frustrating when the final adjustment turns out to be the result of a coin toss. Actually, it is possible to make an arbitrary adjustment which is reasonable.

Due to the nature of Section 482 and the consequent requirements listed in the Internal Revenue Manual, the I.E. responsible for developing a transfer pricing case must gather voluminous information. Obtaining records, documents and testimony from foreign controlled corporations is extremely difficult compared with obtaining the same from U.S. controlled corporations. This situation actually becomes worse where there is an exchange of information agreement with the treaty country. The Internal Revenue Manual requires agents to make a treaty request through National Office for the information before issuing a formal summons.

We met with resistance from some of the taxpayers in gathering the information. They were reluctant to comply with our information requests, because, as subsidiaries, they had no control over their foreign parent corporations. Some of the companies felt we had no right to the foreign based information, and that the burden of complying with our requests was too much. In some cases we issued formal summonses and Section 982 letters. Even in circumstances where we did not issue formal summonses, the process of gathering the data took a lot of time.

After all the time and effort spent by both the IRS and the taxpayer to get information, many times the data is not really that useful for determining a potential adjustment. The foreign information I gathered from my examinations convinced me I could not use either the CUP, the resale price method, or the cost plus method, because no comparables existed, but I already knew that. When I reviewed the preliminary financial statements in the parents' annual reports, I did not really see where the so called hugh profits were shifted, like I could see with U.S. parents and their offshore subsidiaries.

In some cases, combining the parent and the subsidiary would have resulted in no adjustment, had a profit split method been required. This was because there was little or no combined income to split in some circumstances, and in others the combined result of the parent and subsidiary was a net loss.

The ultimate value of the information was that it froze the facts for litigation purposes; but it did not tell me what the arm's length price should be.

I still felt I needed the information because it was important for me to understand what had happened. It seemed the more information I received, the more questions I had. I became painfully aware that I was not going to get the total picture from just looking at the schedules we received. In retrospect seeing the information caused us to rethink our first position, and we tried to make what we thought was a reasonable modification to our proposed adjustment.

Foreign information is not easy to verify. There usually is no one employed by the parent companies available in the U.S. who can explain how schedules are prepared, and what documents are used to prepare them. Also there is no one employed by the parent companies in the U.S. who has personal knowledge of the truthfulness of the data. This is because the companies customarily rotate their executive staff between the company's headquarters and the worldwide subsidiaries.

It was also difficult to make a good analysis of the data because accounting standards and tax laws are very different in the parents' countries of incorporation. A major drawback in my situation was the way consolidated information is reported for financial statement purposes. Apparently, the foreign companies did not have to be consistent with how they included their affiliates in the financial statements. We had no way of knowing whether the major vendors used by the parents for their raw materials, components and subcontracting services were controlled and whether they were operating at arm's length among each other.

I was afraid we were opening a Pandora's box and had to face the fact that we could ask for information until the end of time and not come any closer to an answer. Also, because the records are located in the foreign country, we were not able to make our own verification of source documents or other related items. We finally decided to proceed with the information assuming it provided us with a worse case scenario. In other words, did we feel we had a basis for making an adjustment after considering the effect to the parent corporations. The answer was yes. Despite the operating performance of the parents, the question before me was did the subsidiaries operate as if they were independent. The answer is still no.

A Section 482 examination requires a lot of manpower and other resources; a team of agents, an economist, and an attorney at a minimum, not to mention clerks and accounting aides. Many times progress was slow because there was just not enough personnel to go around. I was extremely lucky in that management agreed to give me a partner, another I.E., and the economists and attorney came on board fairly early. This is not the case in many Section 482 audits. With the current problems IRS has with attracting qualified people, the situation will become worse.

Section 482 audits can be difficult for the auditor, because of the high turnover in IRS management. I had 4 international managers, 2 case managers, 2 district directors and 3 branch chiefs while I was an I.E. Every time there was a management change I had to stop progress on my audits to brief each newcomer.

As a result of so many changes in management, I did not receive the kind of support I needed from management on my cases until the latest case manager. Before that, the only consistent supporter I had was Jim Kamman, the Special International Trial Attorney. Had it not been for him the cases would never have gone as far as they had.

The resources necessary to perform an effective 482 audit include access to supplies, equipment and research facilities. In my situation, I found it necessary to do quite a bit of work at home using my own computer on my own time. One reason this was necessary was that I had spreadsheet and database programs (at home) not available to me from the IRS at the time. I also had to provide diskettes to the economists with spreadsheets in formats they could use, and this was not possible with the equipment and software package made available to me.

It takes a lot of time to examine a pricing case, and this makes the audit more difficult. By the time an examination is started, key people have transferred back to the parent corporation and are not accessible. Documentation gets lost or destroyed in the normal course of business.

International examiners are also under pressure to meet managements production expectations. Sometimes management will not allow the examiner to properly develop the case, issue summonses or interview potential witnesses. The management point of view is that the I.E. holds up the case, even though the biggest issues are international issues and require a lot of development.

This happens in spite of Chapter 600 of the Case Managers Handbook, Section 610(4) which states that the transfer pricing issue requires the commitment of real time and resources to develop and document. If there are indications of a potential transfer pricing case, the I.E. must develop the issue until it is established that no such issue exists.

My wish is that I was able to impress upon you the dilemma faced by every I.E. working transfer pricing cases today. I urge you to carefully consider all points of view, not just those which may appear for the moment to offer a fast solution. This concludes my formal statement. Thank for your attention and your interest.

Chairman PICKLE. Thank you.

The Chair is going to recognize Mr. McNulty and to also remind the panelist that we have a quorum call now followed by four votes on the suspension.

After you finish, Mr. McNulty, we will probably have a recess. It may be as much as 30 minutes because we have four votes that follow. We will have to do the best we can.

If you would proceed, and summarize your statement.

STATEMENT OF NEIL McNULTY, MANAGER OF INTERNATIONAL EXAMINERS, INTERNAL REVENUE SERVICE, MOUNTAINSIDE, N.J.

Mr. McNULTY. I have been a member of the examination division since 1961, and I have been a manager of an examination team since 1976. I am a certified public accountant and a member of the faculty at Seton Hall University. My present position is manager of a field group of international examiners.

My examination experience is that most "distributors" negotiate their distribution agreements to provide the owners/investors with a return on their investment sufficient to justify the amount of capital at risk.

Most distributors experience a gross profit percentage—cost of sales-sales—in substantially the same range, for example, the marketplace demand will dictate the unit selling price while cost of the product will be fairly consistent from supplier to supplier in a noncontrolled environment.

The inefficient middleman will be eliminated if he cannot generate sufficient profit to compensate for capital at risk.

From my experience, in the examination of major electronics distributors that are foreign-owned, is that they defy the general rules of supply and demand. The foreign-owned distributor is subject to the same economic, technical and managerial pressures as independent distributors; however, they rarely provide a return to the parent investor, usually report marginal profits or a loss, and never drop out of the marketplace.

These foreign-owned distributors continue to operate; usually increase their share of the U.S. market, and pay little or no U.S. tax, while operating as the exclusive distributor of the manufacturer's products. The corollary to this is that the foreign parent company is simultaneously reporting increased worldwide sales, profits and dividend distributions to its shareholders.

Analysis of fact patterns also shows a disturbing fact in the application of loss carryforward or carryback deductions in those limited situations where the U.S. distributor shows a profit.

The profit is usually eliminated through the application of a loss carryforward or loss carryback. Over a prolonged period of time, all profit years are offset by losses. Since the supplier controls the price to the distributor, purchase arrangements are at best suspect.

Two coordinated examination program cases that I have recently worked on closely parallel the profile I outlined above.

Case A, a U.S. distributor of a foreign manufacturer of a wide range of consumer products that has operated in the United States for 15 years.

During the 3-year period of the audit, the foreign parent experienced sales growth of approximately 30 percent while the corresponding net income increased by more than 80 percent. During the same period the U.S. distributor which accounted for approximately 10 percent of consolidated sales, reported losses from operations in 2 of the 3 years.

Second, a U.S. exclusive distributing subsidiary of a foreign manufacturing parent company, operating in the United States since the early 1960's. For a recent 5-year period the U.S. distributor accounted for 25 to 30 percent of worldwide sales of several billion dollars.

The parent company had fluctuating profits and the U.S. distributor contributed approximately 25 to 30 percent of the profits. The U.S. distributor however, availed itself of loss carryforwards and virtually eliminated the U.S. tax liabilities for the years under my review.

My opinion on the causes of the losses lies in three separate areas: One, excessive purchase prices for goods purchased from the parent company; two, the cost attendant to the financing of merchandise purchased, and three, the costs of promoting and providing warranty services for products in the U.S. market.

One, excessive purchase price—the gross profit percentage for the U.S. company is comparable to that experienced by independent distributors. The difficulty is that we are unable to compare the elements included in the unit purchase price.

Foreign manufacturers have consistently refused to supply manufacturing cost data, standard costs, and operating profits on a product-by-product basis. In addition, since the industry is dominated by foreign suppliers, the comparison of gross profits is meaningless as all the companies in the pool are foreign-owned and all have minimal profits.

Two, costs for financing merchandise—the situation in the cases under my jurisdiction is that the U.S. distributor has interest charges which are higher than experienced by U.S. based competitors. In one of our cases the taxpayer had interest expense that amounted to over 8 percent of sales in 1 year and over 5 percent of sales in the next year. The IRS "Statistics of Income" during the same period reports average interest of 1.6 percent of the sales for U.S. entities.

The inventory is financed through letters of credit and short-term borrowing with foreign banks usually guaranteed by the foreign parent. The inventory value is sufficient to secure the debt and this weakens any arguments that the interest is allocable to the manufacturing parent.

I think one of the things brought out in section 982, a recommendation that if we could modify the statute in section 6501 to provide for suspension in a statute from the day a formal document request—under section 982—is issued to the date a fully acceptable response is received.

Two, restructure and streamline the summons enforcement process to delegate it to IRS.

Three, modify existing procedures to deny the privilege of taking a case to appeals, where incomplete pricing information is a factor. By mandating that a petition be filed with the Tax Court, the proposed deficiency would become public information requiring disclosure to shareholders and regulatory authorities.

This would serve to discourage the attitude that failure to cooperate is an effective tax planning strategy.

In closing, I can only state that the development of a pricing case is a difficult proposition in an extremely complex area. Any legislation requiring more meaningful recordkeeping requirements can only assist international examiners in making informed judgments on the correctness of inter-company pricing arrangements.

[The prepared statement follows:]

STATEMENT OF
NEIL MCNULTY
BEFORE THE
OVERSIGHT SUBCOMMITTEE
COMMITTEE ON WAYS AND MEANS

JULY 10, 1990

I am Neil McNulty, a manager in the Internal Revenue Service. I have been a member of the Examination Division since 1961 and have been a manager of examination teams since 1976. In addition, I am a Certified Public Accountant and a member (part-time) of the faculty at Seton Hall University. My present position is manager of a field group of International Examiners.

The electronics industry, in both manufacturing and distribution, is subjected to severe economic and technological obsolescence pressures and there is a long history of companies dropping out of the distribution network due to either one or both of the above factors.

My examination experience is that most "distributors" negotiate their distribution agreements to provide the owners/investors with a return on their investment sufficient to justify the amount of capital at risk. Most experts generally agree that the distribution business is not particularly complex, but rather is governed by an understanding of the market and good management. In an article in the San Francisco Times, May 25, 1987, Bill Leimbach, a partner in the firm of Touche, Ross & Co (now Deloitte, Touche & Co) stated that "its not a difficult business. All it requires is keeping track of inventory, keeping as little inventory on hand as possible, yet being able to deliver the goods, ... Managing is the key to winning in any kind of wholesale business." This statement is probably overly simplistic when applied to the electronics industry, as it discounts the severe economic, obsolescence and competitive pressure that are ever present. The growth of large retailing chains oft times give them the strength to deal directly with manufacturing and by pass the middleman (wholesale distributor). Business Week suggests that there will be a decrease in U.S. wholesalers of 35,000 (320,00 down to 285,000) between 1985 and 1990. (1)

Most distributors experience a gross profit percentage (Cost of Sales/Sales) in substantially the same range; i.e., the market place demand will dictate the unit selling price while cost of the product will be fairly consistent from supplier to supplier in a non-controlled environment. The inefficient middleman will be eliminated if he cannot generate sufficient profit to compensate for capital at risk.

From my experience, in the examination of major electronics distributors that are foreign owned, is that they defy the general rules of supply and demand. The foreign owned distributor is subject to the same economic, technical, and managerial pressures as independent distributors; however, they rarely provide a return to the parent investor, usually report marginal profits or a loss, and never drop out of the market place. These foreign owned distributors continue to operate; usually increase their share of the U.S. market, and pay little or no U.S. tax, while operating as the exclusive distributor of the manufacturer's products. The corollary to this is that the foreign parent company is simultaneously reporting increased worldwide sales, profits and dividend distributions to shareholders.

Analysis of fact patterns also shows a disturbing fact in the application of loss carryforward deductions in those limited situations where the U.S. distributor shows a profit. The profit is usually eliminated through the application of a loss carryforward or loss carryback over a prolonged period of time, all profit years are offset by losses. Since the supplier controls the price to the distributor, purchase arrangements are most suspect.

Two Coordinated Examination Program cases that I have recently worked on closely parallel the profile I outlined above and I will discuss them independently, though their fact patterns are similar.

Case A - A U.S. distributor of a foreign manufacturer of a wide range of consumer products that has operated in the U.S. for fifteen years. During the three year period of the audit, the foreign parent experienced sales growth of approximately 30% while the corresponding net income increased by more 80%. During the same period the U.S. distributor which accounted for approximately 10% of consolidated sales, reported losses from operations in two of the three years.

Case B - A second U.S., exclusive distributing subsidiary of a foreign manufacturing parent company, operating in the U.S. since the early 1960's. For a recent five year period the U.S. distributor accounted for 25% to 30% of worldwide sales of several billion dollars. The parent company had fluctuating profits and the U.S. distributor, however, availed itself to loss carryforwards and carrybacks and virtually eliminated the U.S. tax liabilities for the years under review.

My opinion on the causes of the losses lies in three separate areas:

1. Excessive purchase prices for goods purchases from the parent company;

2. The cost attendant to the financing merchandise purchased; and

3. The costs of promoting and providing warranty services for products in the U.S. market.

1. Excessive Purchase Price - the gross profit percentage for the U.S. company is comparable to that experienced by independent distributors. The difficulty is that we are unable to compare the elements included in the "unit purchase price". Foreign manufacturers have consistently refused to supply manufacturing cost data, standard costs, and operating profits on a product by product basis. In addition, since the industry is dominated by foreign suppliers, the comparison of gross profits is meaningless as all the companies in the pool are foreign owned and all have minimal profits.

2. Costs for Financing Merchandise - the situation in the cases under my jurisdiction is that the U.S. distributor has interest charges which are higher than experienced by U.S. based competitors. In one of our cases the taxpayer had interest expense that amounted to over 8% of sales in one year and over 5% of sales in the next year. The IRS "Statistics of Income" during the same period reports average interest of 1.6% of the sales dollar. The inventory is financed through letters of credit and short-term borrowing with foreign banks usually guaranteed by the foreign parent. The inventory value is sufficient to secure the debt and this weakens ant arguments that the interest is allocable to the manufacturing parent.

An additional fact that has surfaced is that the letter of credit interest is paid up front while the distributor offers favorable terms to its retail customer, in one case over 100 days. This means the distributor is paying currently and not receiving sales proceeds for unnecessarily long periods of time.

3. Costs of Promoting Product in U.S. Market - the second most significant line item on the distributors return is the advertising and promotion costs. Arguments that this expense is properly allocable to the manufacturer have been unsuccessful. The product is promoted in the U.S. market at the retail level. In some recent domestic cases we have argued that the distribution arm deserves the return on marketing efforts. To posture ourselves now that promotion costs are allocated to the manufacturer is inconsistent with those cases. Additionally, parent companies argue that the advertising reimbursement is built in the price to the distributor.

Problems Encountered in Applying U.S. Tax Law - Regulation 1.482-2(e) requires the priority ordering of prices, first to the "comparable uncontrolled price" (CUP), then the "resale method", then to the use of "cost plus". Since valid comparables rarely exist, it is necessary to use the resale method which require a reasonable gross profit. As noted earlier, gross profits can often be reasonable under U.S. standards of cost accounting; however, if the interest, advertising, and promotion were included in the cost of sales, the gross profit percentage would be greatly reduced or virtually eliminated. In addition, the absence of knowledge of the manufacturer per product costs and profits inhibit proper case development.

Usefulness of Section 982, 6038A, and 1059A - I am unable to comment on the usefulness of these sections from experience as I have not yet had the occasion to invoke these provisions. Section 982 prohibits the introduction, in a civil proceeding, any information which was not presented in response to a formal document request for foreign based information. Since taxpayer's claim the appropriateness of their pricing policies under the resale method, using gross profits. I am not sure that the failure to comply with a formal document request under Section 982 has the impact that the legislative drafters had planned. The denial of the right to submit information from overseas will not, of itself, support a challenge to a proposed pricing arrangement. To properly develop a case under Section 1.482-2(e), (sufficient to counter taxpayer's arguments) demands in depth analysis by experienced revenue agents and economists. We have not been too successful in Section 482 pricing cases in the Tax Court and this factor, coupled with lack of cooperation by taxpayers and statute of limitation problems, inhibits case development.

Suggestions for Improvements to the Program:

1. Modify the Statute of Limitations Code Section 6501 to provide for the suspension of the statute from the day a formal document request (under Section 982) is issued to the date a fully acceptable response is received.

2. Restructure and streamline the summons enforcement process to delegate it to IRS.

3. Modify existing procedures to deny the privilege of taking a case to Appeals, where incomplete pricing information is a factor. By mandating that a petition be filed with the Tax Court, the proposed deficiency would become public information requiring disclosure to shareholders and regulatory authorities. This would serve to discourage the attitude that failure to cooperate is an effective tax planning strategy.

In closing, I can only state that the development of pricing case is a difficult proposition in an extremely complex area of tax law. Any legislation requiring more meaningful recordkeeping requirements can only assist international examiners in making informed judgements on the correctness of inter-company pricing arrangements.

Footnote: (1) Business Week, January 9, 1989, P. 91

Chairman PICKLE. Thank you.

Your statement will be very helpful.

When we return, Mr. Milano will be asked to present his testimony.

As I said, we will have four votes. It may be a little less than 30 minutes, but we will be back within that time.

We stand in recess for approximately 25 to 35 minutes.

[Brief recess.]

Chairman PICKLE. I thank the panelists and the others for waiting.

Our next witness will be Mr. Lou Milano, an international examiner from Mountainside, N.J.

STATEMENT OF LOUIS MILANO, INTERNATIONAL EXAMINER, INTERNAL REVENUE SERVICE, MOUNTAINSIDE, N.J.

Mr. MILANO. Mr. Chairman, I am currently an international examiner in Mountainside, N.J. I have held this position for 4 years and have been directly involved in the examination of inbound electronic pricing cases for 2½ years.

This statement will contain an overview of the tax issues associated with foreign owned electronic equipment distributors and how these issues were determined based on this international examiner's experience. I have been examining several U.S. electronic distributing subsidiaries that have foreign manufacturing parents. These distributors, for the years 1983 through 1985, paid very little or no U.S. tax.

My experience with auditing these distributors indicates that this marginal profit performance is hardly attributable to inefficient management. Pricing of goods purchased from the foreign parent or performance of functions not properly compensated by the foreign parent appear to be the main causes for the marginal profit performance as compared to the levels of profitability of the U.S. distribution industry in general, specific examples will follow.

In order to make the above determination, it is necessary to obtain relevant, accurate, and contemporaneous information concerning related and unrelated third party transactions. In the beginning of an audit, I utilize a three step approach to analyze the potential for noncompliance. This approach is prior to utilizing priority or prior to issuing document requests.

Step 1 is to profile the controlled distributor. Step 2 is to profile the distributor based on industry data and step 3 is to compare controlled industry data to other industry data. This entails analyzing the business, functions, market levels, size of distributor, type of products it sells and the specific relationships that exist between the distributor and its customers.

I also analyze the controlled distributors' gross and net profit margins. I also analyze key financial ratios, some of those being the Berry ratio, gross profit divided by operating expenses, return on assets and inventory turn over.

Finally I examine the functions controlled, purchasing of goods, fiscal distribution; warehousing, marketing and promotion, warehousing and reselling. The second step is profiling the independent distributor based on industry data. For electronics distributors, the code is 5064. I analyze the profit margins based on the code, gross and net profit margins. I also analyze key financial ratios under the standard industry code. I then compare the controlled distributor data to industry data to determine if deviations exist between the data in step 1 and data in step 2 and if so I inquire in to transfer pricing.

The most appropriate way to illustrate the above steps is through a comprehensive example utilizing hypothetical data of three electronic distributors with related foreign manufacturing parents and comparing the data to industry norms to see if any deviations exist which would be an indicator of possible noncompliance.

I refer the chairman to exhibit 1 on page 3 of my statement. I will just highlight three key percentages. The key percentages I will highlight are the gross profit percentage, operating expense percentage and operating profit percentage. The gross profit is the net sales less the cost of goods sold. As you can see on line 3, for Company A, B, and C that is respectfully 30 percent, 26 percent and 9 percent. When I compare that to industry data that is published, industry data averaged around 22 percent.

Mr. Chairman, if we were to stop at this point it would appear that company A and B are performing above industry norms and that company C is performing below industry norms. For companies A and B a potential transfer pricing probably may not exist using the strict industry data. But we need to look at below the line functions and their corresponding cost. When doing this we find out that companies A and B expend far more money than the industry norm.

In this example it is 31 to 19 percent which was the industry norm. Company B was 23 to 19 and company C was 9.5 to 19 percent. When we look at above and below the line expenses we find our companies are not performing like the industry performs.

Now we need to go into a more thorough pricing probe. That is the point that I am trying to get across, that we must look at each and every company on an overall basis and not accept anything on face value. Comparison with industry data is only a tool that helps in identifying potential pricing problems. It is not all conclusive. Other causative factors of why related distributors are able to avoid tax are higher transfer prices paid by related distributors. Related distributors' and independent distributors' ultimate goal is to determine the FOB price they need to pay that will enable them to cover expenses and make a profit.

Since the related distributor is a sole source distributor or with the foreign parent as its exclusive supplier its ability to attain the FOB amount is nearly impossible. If the foreign parent will not manufacture the product for the FOB amount, the distributor does not have the convenience or the luxury of taking its business elsewhere. They have to pay the higher transfer price which ultimately reduces its profit. The independent distributor, however, does attain the FOB amount which allows it to obtain its profit goals because it has the ability to seek out a supplier who will manufacture its product at the FOB amount.

Terms of purchase; terms of sale—The taxpayers I am examining usually purchase products from their foreign parent at terms of FOB, freight on board, at site using letters of credit or bankers acceptance. This policy is usually dictated by the foreign parent supplier.

On the other hand, the related distributor is selling products in this country to dealers at very favorable terms, 60 to 120 days, so that they will be able to gain market share. This policy, which has approval of the foreign parent, severely hinders the related distributor from achieving profit goals since the interest expense to finance inventory is much greater than industry or independent distributors would ever anticipate or actually incur.

One final causative factor I would like to highlight is operating expenses. Related distributors are incurring greater operating expenses for functions performed when compared to industry norms. This is one more factor to considered in determining the extent of tax avoidance, increased expenses, which generates a question, are related distributors properly compensated by their foreign parent for functions they perform?

In summary, my statement has outlined how I determine if potential noncompliance exists with related distributors in the electronics industry. I have also pointed out other causative factors of how these related distributors avoid paying U.S. tax.

Given the absence of good comparables, we are left with resorting to other methods which largely are untried and untested in the courts.

Chairman Pickle. Thank you.

[The prepared statement follows:]

STATEMENT OF

LOUIS MILANO

BEFORE THE

OVERSIGHT SUBCOMMITTEE

COMMITTEE ON WAYS AND MEANS COMMITTEE

JULY 10, 1990

Brief Biography:

My name is Louis Milano, I have been an employee of the Internal Revenue Service since 1979. I am currently an International Examiner in Mountainside, New Jersey. I have held this position for 4 years and have been directly involved in the examination in Inbound Electronic Pricing cases for 2 1/2 years.

Introduction:

This statement will contain an overview of the tax issues associated with foreign owned electronic equipment distributors and how these issues were determined based on this International examiner's experience. I have been examining several U.S. electronic distributing subsidiaries that have foreign manufacturing parents. These distributors, for the years 1983 through 1985, paid very little or no U.S. Tax.

My experience with auditing these distributors indicates that this marginal profit performance is hardly attributable to inefficient management. Pricing of goods purchased from the foreign parent or performance of functions not properly compensated by the foreign parent appear to be the main causes for the marginal profit performance as compared to the levels of profitability of the U.S. distributed industry in general (specific examples will follow).

In order to make the above determination, it is necessary to obtain relevant, accurate, and contemporaneous information concerning related and unrelated third party transactions. In the beginning of an audit, I utilize a three step approach to analyze the potential for non-compliance.

Step 1 - Profile the Controlled Distributor

A) Analysis of the Controlled Distributors Business

1) Functions Performed

2) Market(s) to which the distributor sells

3) Size of distributor

4) Type of product distributor sells

5) Specific relationships between distributor and its customers and suppliers

B) Analysis of Profit Margins

1) Gross Profit Margin - Gross Profit (sales less cost of goods sold) Divided by net sales

2) Net Profit Margin - Net Profit (gross income less total deductions) Divided by net sales

C) Analysis of Key Financial Ratios

1) Berry Ratios with and without interest expense (Berry Ratio equals gross profit divided by operating expenses)

2) Return on assets - (net sales divided by total assets)

3) Inventory turnover - (cost of sales divided by inventory)

4) Debt to equity - (total liabilities divided by tangible net worth)

5) Receivables and Payables - (net sales divided by trade receivables) (cost of sales divided by trade payables)

D) Analysis of Functions Performed - (generally six functions for distributors)

1) Purchasing goods from supplier

2) Physical distribution of goods

3) Warehousing of goods in large quantities (ready availability for purchases)

4) Marketing and promotion

5) Providing services (ex. warranty)

6) Reselling goods

Step 2 - Profile the Independent Distributor Based on Industry Data

1) Determine comparable industry data based on SIC code (standard industry code) (electronic distributors SIC code 5064)

2) Analysis of profit margins by SIC code
a) Gross profit margin
b) Net profit margin

Step 3 - Compare Controlled Distributor Data to Industry Data

1) Determine if deviations exist between the data in Step 1 and the data in Step 2; if so, further inquiry into transfer pricing maybe justified.

The most appropriate way to illustrate the above steps=s is through a comprehensive example utilizing hypothetical data of three electronic distributors with related foreign manufacturing parents and comparing the data to industry norms to see if any deviations exist which would be an indicator of possible non-compliance. (see exhibit 1 &2 for illustration)

EXHIBIT 1

ANALYSIS OF PROFIT MARGINS

	Company A	Company B	Company C
1) Net Sales	500,000,000	1,500,000,000	200,000,000
2) Cost of Goods Sold	350,000,000	1,125,000,000	182,000,000
3) Gross Profit (1-2)	150,000,000	390,000,000	18,000,000
Gross Profit % (3/1)	30%	26%	9%
3a) Industry Profit	22%	22%	22%
4) Advertising and Promotion	70,000,000	145,000,000	5,000,000
5) Selling Expense	35,000,000	33,000,000	2,000,000
6) Warranty Expense	10,000,000		1,000,000
7) Interest Expense	10,000,000	19,000,000	1,000,000
8) Other Operating Expense	30,000,000	148,000,000	10,000,000
9) Total Operating Expense	155,000,000	345,000,000	19,000,000
Operating Expense % (9/1)	31%	23%	9.5%
9a) Industry Operating Expense %	19%	19%	19%
10) Operating Profit (3-9)	(5,000,000)	45,000,000	(1,000,000)
Operating Profit % (10/1)	(1%)	3%	(.5%)
10a) Industry Operating	3%	3%	3%

EXHIBIT 2

ANALYSIS OF KEY FINANCIAL RATIOS

	Company A	Company B	Company C
1) Berry Ratios Gross Profit Operating Expenses	.97	1.13	.95
1a) Industry Berry Ratio	1.14	1.14	1.14
2) Return on Assets Net Sales Total Assets	2.9	2.9	2.4
2a) Industry Ratio	2.9	2.9	2.9
3) Debt/Equity Total Liabilities Tangible Net Worth	5.0	2.2	150.0
3a) Industry Ratio	3.7	3.7	3.7

Through the use of the illustration, I demonstrated a few of the causative factors which provide preliminary indications whether potential non-compliance exists and how related distributors can avoid paying U.S. Tax. (low profit margins and excessive operating expenses as compared to industry norms).

Other causative factors of why related distributors are able to avoid paying U.S. tax based on my experience to date are:

1) Higher transfer price paid by related distributor compared to independent (unrelated distributor) - Related distributors ' and independent distributors' ultimate goal is to determine the Freight On Board (FOB) price they need to pay their foreign manufacturing supplier(s) that will enable them to cover their expenses and make a profit. A brief discussion of how the FOB amount is arrived at is warranted

   The price that electronic products sell for in the U.S. is market driven. The starting point, therefore, for distributors, is the suggested retail price to the U.S. consumer. From this amount, the distributor backs out dealer profit margins (known in the industry) to arrive at the dealer purchase price. From this amount, the distributor backs out its landed costs (both fixed and variable) based on gross and net profit margin goals. From this amount, the distributor finally backs out the cost of transporting the products into this country to arrive at the FOB amount the distributor needs to pay its foreign supplier in order to obtain the necessary profit margins needed to cover expenses and make a profit.

   Since the related distributor is a sole source distributor (foreign parent is exclusive supplier), its ability to attain the FOB amount is nearly impossible. If the foreign parent will not manufacture the product for the FOB amount, the distributor does not have the convenience or luxury of taking its business elsewhere. They have to pay the higher transfer price which ultimately reduces its profit. The independent distributor, however, does attain the FOB amount which allows it to obtain its profit goals because its has the ability to seek out a supplier who will manufacture its product at the FOB amount.

2) Terms of purchase; terms of sale - The taxpayers I am examining, usually purchase product from their foreign parent at terms of FOB (Freight On Board) at sight using letters of credit or bankers acceptance. This policy is usually dictated by the foreign parent supplier.

   On the other hand, the related distributor is selling products in this country to dealers at very favorable terms (60 - 120 days) so that they will be able to gain market share. This policy (which has approval of the foreign parent) severely hinders the related distributor from achieving profit goals since the interest expense to finance inventory is much greater than industry or independent distributors would ever anticipate or actually incur.

3) Operating expenses - Related distributors are incurring greater operating expenses for functions performed when compared to industry norms. This is one more factor to be considered in determining the extent of tax avoidance (increased expenses), which generates a question - Are related distributors properly compensated by their foreign parent for functions they perform?

In summary, my statement has outlined how I determine if potential non-compliance exists with related distributors in the electronics industry. I have also pointed out other causative factors of how these related distributors avoid paying U.S. tax.

Given the absence of good comparable, we are left with resorting to other methods which largely are untried and untested in the courts.

Chairman PICKLE. Now we will hear from Patrick Kelly, case manager from Newark, N.J.

STATEMENT OF PATRICK KELLY, CASE MANAGER, INTERNAL REVENUE SERVICE, NEWARK, N.J.

Mr. KELLY. Thank you, Mr. Chairman. I began my career with the Internal Revenue Service in 1972 as a co-op student. I have been a manager in examination since 1979. I became a case manager in the coordinated examination program, CEP, in July 1989. I am a certified public accountant licensed to practice in the State of New Jersey, an adjunct professor at a New Jersey university and an instructor for a national CPA review course.

From my experience in the examination of major foreign owned electronic distributor cases, I can only state that in most instances the companies reflect marginal profits or continued losses.

In my opinion, the causative factors for the results of their operations are numerous. They result in part from rapid technical obsolescence, competitive pressures and related party dealings between the domestic subsidiary and the foreign parent corporation. These factors lead to the enigma that many U.S. distributors owned by a foreign parent manufacturer, operate at a loss, yet continue in existence.

Perhaps the best means available to provide an overview of noncompliance by foreign electronics equipment distributors is to provide an example. This example is not a recount of the fact pattern of a single case, but rather a composite of several cases. The methodology employed in this illustrative case may be representative of "industry practices."

Company A is a 100 percent U.S. subsidiary of its foreign parent company. During a 12-year period, the company reported sales in the United States of several billion dollars. Through effective use of the net operating loss carryback and carryforward provisions of the Internal Revenue Code, there was no net tax liability.

In order to understand how company A reduces the results from operations to a loss, a basic understanding of an income statement is required. Sales, less cost of goods sold, equals gross margin. The sales dollars are generated by the demand for the product by unrelated parties, which are beyond the control of the company.

The purchase price for inventory, in the case of a foreign distributor, is the result of negotiations between the foreign parent and its domestic subsidiary. Under the requirements of section 482 of the Internal Revenue Code, this negotiated price should be an arm's-length price, that is, a price that an unrelated buyer would pay to an unrelated seller. Since the parent and its 100-percent owned subsidiary are related, this transfer price is suspect because it can be manipulated. The cost of purchases is a major factor in determining the cost of goods sold. The resulting gross profit represents the amount available to pay for expenses. In this case, the gross profit, based on the return filed, fluctuates from period to period, but averages approximately 30 percent.

A significant expense which appears consistently throughout the period in question is advertising and promotion. This expense can range from 10 to 17 percent of sales per year. As much as 17 cents of each sales dollar is expended to promote the product in the U.S. market. These advertising budgets, I believe, are influenced by the foreign parent. The parent company can argue that the reimbursement for these expenditures are included in the transfer price. This would reduce the gross margin from 30 to 13 percent.

Another typically material expense in a foreign distributor case is interest. High inventory levels are maintained. In a nonforeign distributor case, inventory is generally kept low. These high inventory levels tie up a great deal of capital. There tends to be significant liabilities due to either the parent company and/or foreign lenders, with the inventory used as collateral. This interest expense further reduces net income. It is unclear if there exists any relationship between the foreign lending institutions and the parent company, but quite often the parent is the guarantor of the loans. If interest expense was 7 percent of sales, then gross margin is reduced to 6 percent. The company has 6 cents of each sales dollar available to pay all other expenses.

It is the contention of the company that their profit and loss pattern is caused to a large extent by the introduction of new technology and products in the U.S. market. From my experience, manufacturing costs tend to become fixed and fairly stable. Based on the demand by the U.S. consumer, the new items command a higher selling price resulting in profit. In subsequent years, similar products are introduced by competitors and this competition reduces the margin on the sale. Also, absent the introduction of new technology, the inventory ages and commands a reduced gross profit. I believe the timing of the introduction of new products and the decision as to whether the technology should be introduced into the U.S. market offers further flexibility in determining results from operations.

Through this methodology, a company can manipulate profit and/or create losses and avail themselves of the net operating loss provisions of the Internal Revenue Code.

On the top of the next page I prepared a schedule that shows how carryback and carryforward provisions are applied. I will request that that be entered into the record.

It should be noted that net operating loss and carryforward and carryback provisions are available and utilized by domestic U.S. companies without foreign ownership. These losses are generally the result of normal business cycles and prevailing economic conditions. However, the pattern that has developed and the inter-company dealings of foreign controlled companies has raised my suspicion.

I believe that the foreign parent's ability to influence the budget process for certain costs combined with the ability to operate at other than arm's length regarding the transfer price affords the company the opportunity to manipulate the tax liability of the U.S. subsidiary.

Chairman Pickle. Thank you.

[The schedule referred to follows:]

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12
Profit/Loss as filed	loss	loss	profit	profit	profit	profit	loss	loss	profit	profit	profit	loss
Carryforward/back	-	-	c/f	c/b	c/b	c/b	-	-	c/f	c/b	c/b	-
Net tax	0	0	0	0	0	0	0	0	0	0	0	0

Chairman Pickle. I believe our last witness will be Mr. Paul Chmiel from the Mountainside office.

STATEMENT OF PAUL Z. CHMIEL, INTERNATIONAL EXAMINER, INTERNAL REVENUE SERVICE, MOUNTAINSIDE, N.J.

Mr. Chmiel. Thank you, Mr. Chairman.

My name is Paul Z. Chimel and have been with the Internal Revenue Service since 1967. I am currently an international examiner from Mountainside, N.J., and have been in that position for the past 15 years.

I have been involved with inbound pricing for the past 10 years and have encountered numerous problems in the development of these cases. Some of these problems have been eliminated through changes in legislation.

The regulations under section 482 prescribe the methods for analyzing transfer pricing issues and regardless of the method utilized, it is necessary to obtain relevant, accurate and contemporaneous information concerning the related party transactions in order to develop and determine if a pricing adjustment is warranted.

Generally speaking, either the comparable uncontrolled price method or the resale price method applies to inbound pricing cases. In either case, a comparable product or company must be found. Herein lies the most difficult problem encountered by an international examiner.

In the case of comparable products, the U.S.-related company generally does not have the information which can only come from the offshore manufacturer. If not voluntarily supplied by the parent, we have no means to legally obtain this data. The recent amendments to section 6038A will be helpful in this regard, however if the statute was amended to apply to all open years, enforcement proceedings would be greatly enhanced. If the data is supplied and we determine that the offshore manufacturer is selling private label goods, the next task is to determine what products are identical or almost identical and quantifying any differences to make them identical.

Obtaining data from other sources regarding comparability such as from trade publications and product specifications may sound easy when you have one product containing five models; however, consider more than one product with 200 different models and you can see the arduous task ahead.

In addition to the above, consideration must be given to trademark, quality, volume, et cetera, and the ability to quantify any differences between products.

What we have just been through may have represented approximately 5 to 10 percent of the total purchases from offshore. What do we do with the balance of the products?

In the ordering rules provided under the 482 regulations, the balance may come under the resale price method. Once again we are faced with the arduous task of locating comparable companies performing similar functions as the related U.S. distributor and obtaining the necessary data for comparison. Once this data is obtained and differences are identified, we adjust for any significant differences.

Concerning the public data available, such as SEC forms, 10K or annual reports the problems encountered is the use of a consolidated statement, consisting of manufacturing, operations, service operation and distribution, and unless we are able to obtain a breakdown for the distribution segment only, the information is not a good comparison.

Through my experience, it is critical to the proper development of any transfer pricing case to obtain data from third parties. We get this information through the use of summonses. Although this sounds easy, several problems arise; the first and most common is the age of the documents requested. At times the records have been destroyed, are incomplete, and are not available in the form necessary for comparative analysis.

Another important phase in dealing with third parties is interviewing knowledgeable people that negotiated prices, signed contracts and made visits to the Far East factories. Again, many problems may arise in that the knowledgeable people during the timeframe involved are no longer with the company.

Sensitivity and confidentially are also encountered when requesting third party data. The concern that most third parties have is disclosure to competitors or to the taxpayer we have under examination.

Another source of information available to an international examiner is U.S. Customs data. Once familiar with Customs forms and their computer printouts, we are able to locate necessary documents to make comparative pricing analysis. The only problem encountered is the information received may not be disclosed to the taxpayer under examination thereby forcing us to obtain the same data either from the offshore manufacturer or the U.S. unrelated distributor.

I am pleased that you asked me about support and training. In May of 1989, the Office of Chief Counsel established the field international support team with the purpose of coordinating international issues throughout the Nation. Through this support, we are kept abreast of current developments regarding transfer pricing issues and also are provided legal support related to summonses, disclosure problems, and the supportive development of our cases.

In addition to the field international support team, the electronic component industry program was established to coordinate and disseminate information throughout the nation.

The basic classroom training given to international examiners is excellent and is conducted in two phases. The first phase, international issues—unit I, provides an overview of the international areas that an examiner is likely to be confronted with in their day-to-day activities.

The second phase, international issues—unit II, provides a more comprehensive study of the areas covered in unit I.

In 1986, and in order to complement the classroom training, both myself and another senior examiner developed an international training program for the Newark district relating to on-the-job-training. We created a formal curriculum and developed a series of specific objectives to ensure that the trainees were exposed to the full spectrum of the international examiner's job.

Trainees are assigned their own cases and a senior international examiner as a coach. This permits the trainee to utilize and draw from the expertise of their coach in the development of their skills, and enables the trainee to grow into and become a member of a large case audit team. They are then given responsibility for certain audit areas with the ultimate goal of allowing the international examiner to progress to the point whereby they are assigned their own inventory of large cases.

Last, we planned and conducted several workshops on specific topics that are important at this time period; for example, Puerto Rico Pricing, section 936, and Domestic International Sales Corporation, DISC. At these workshops, senior international examiners made presentations and as the trainees progressed, they were given topics and made their own presentations. This developed their communication skills, research ability, report preparation, interpretation and application of the tax law.

I hope the above has answered your questions and has provided the background for an international examiner. This background can only be obtained through years of training and experience. As such, it requires an accounting background to audit books and records and analyze financial statements, indepth training in International tax law experience in auditing and investigative skills, knowledge of the industry and awareness of global economics.

Chairman PICKLE. All right. Thank you. I realize this has been a long day and you testified this morning not only in closed session, but in addition have presented now your statements in public.

This will be a source of close study by members of this committee, and we are glad to have your statements and we thank you for your cooperation. You people are out on the front line, in the trenches as you like to say, but you and your people live sometimes in these corporate offices, so you are in a position to know better perhaps than anyone what is actually happening.

So I thank you for your testimony and hope that as we make further contact with you that you will give us additional information with any suggestions you have, and we urgently solicit that information from you now.

At this time I would like for Mr. Romoff to take a seat here at the front again. We are going to have discussions about the testimony that we have heard from you and from the Commissioner and from others, so to the extent that you can join in with us we invite you to participate.

Mr. Flippo is going to lead off with a question now joined by Mr. Shaw. I think they will concentrate primarily in the electronics field. Following later will be Mr. Anthony and Mr. McGrath with automobiles. And we will have Commissioner Goldberg back with us.

Now I want to yield to Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

I had a question or two for the Commissioner. I see he is not in the audience at the time, perhaps he will return. I really don't know who we should direct this question to, perhaps you could assist us.

In the most recent tax return data that was obtained by the subcommittee for 1987 it showed that 14 electronics companies reported $20 billion in gross receipts and yet owed $38 million in corporate income taxes, that is less than one-tenth of 1 percent, and after factoring in operating losses they would certainly be even lower than that. Is that essentially true?

Mr. Milano or Mr. McNulty, who should respond to this question?

Mr. **McNulty**. I think that is a fair assessment. We have in our possession papers presenting statistical data that we have from our cases, and for the most part——

Mr. **Flippo**. Does the electronics distributor industry show a greater transfer pricing problem than the car or the motorcycle industry? Can anyone answer that?

Mr. **McNulty**. I think not. I think it is consistent. It is a matter of just placing the profits at the manufacturer level, not at the distributor level.

Ms. **Lewin**. I would say the electronics industry is a bigger problem. In the auto companies you are seeing some sort of tax paid and profits reported, it is just that it is not enough for an arm's-length transaction.

Mr. **Flippo**. So there seems to be a deliberate plan to plan their profits and loss cycles, and the operating losses that can be used to recoup the taxes or to avoid paying taxes?

Ms. **Lewin**. That is a fair generalization. They have a couple of exceptions of taxpayers who have paid tax, electronics companies on a continuous basis, but for the most part where you have a company with $100 million NOL carryforward, that I think ties into what Mr. McNulty was saying.

Mr. **Flippo**. I think the subcommittee reviewed one company that had never paid any U.S. taxes since it began operations more than a decade ago. It has constantly shown losses each year. Can you think of any way that such a company can stay in business when it hasn't had profits in 10 years?

Ms. LEWIN. Not an uncontrolled distributor. Obviously—again this is my opinion, that this is allowed to go on because the profits are all reported by the manufacturer. It is not an overall loss.

Mr. FLIPPO. Has the IRS ever asserted a penalty against any of these electronics distributors who underpay their U.S. taxes or don't pay year after year, to your knowledge?

Mr. KELLY. Yes.

Mr. FLIPPO. Is that a normal thing?

Mr. KELLY. Depending on the facts and circumstances of the case.

Mr. FLIPPO. Would you clarify it as frequent that penalties have been applied?

Mr. KELLY. There is no way of knowing the universe.

Mr. FLIPPO. Where penalties and interest are applied, are they deductible?

Mr. KELLY. No. Interest is deductible, penalties are not.

Mr. FLIPPO. Even though an individual cannot deduct that, is that correct?

Ms. LEWIN. That is correct. I believe this year they are allowed to deduct 10 percent of the interest and next year it is zero.

Mr. SHAW. Would the gentleman yield? I think it needs clarification. Ms. Lewin said the profits are reported by the manufacturer. The manufacturer in this regard is beyond the reach of the IRS, I would assume.

Ms. LEWIN. That is correct.

Mr. SHAW. Are they paying taxes anywhere? What we have here is one of the most lucrative industries in the United States today, the electronics industry which is almost totally foreign manufactured, paying basically zero income taxes in the United States, is that a correct statement?

Ms. LEWIN. Yes, sir.

Mr. FLIPPO. With regard to the penalties, you say IRS has assessed penalties. Have penalties actually been paid? Could Treasury—I am not trying to get you to name the individual company, tell me if penalties paid frequently by these companies that have been assessed by IRS? are they protesting the penalties?

Mr. KELLY. Yes. In docketed——

Mr. FLIPPO. To your knowledge, have there been any penalties actually paid?

Mr. KELLY. No, sir.

Mr. MCGRATH. Would the gentleman yield?

Chairman PICKLE. Do any of you have knowledge about penalties?

Mr. MCGRATH. They will sit down and come to some agreement in a case like this, and most of what is paid is an assessment plus interest, and the interest of course is deductible in their next year's tax return.

Chairman PICKLE. In some instances they have deducted interest the following year too.

Mr. LOWRY. The question about penalties, often penalties are imposed at the examination level. Quite often when that case goes forward in our process at appeals level, often a penalty is abated at the appeals level and never is paid.

Mr. **Flippo**. Looking at the charts presented by the Commissioner and other data, some people observe this data and try to compare it to similar data for U.S.-owned companies and some conclude that foreign owned subsidiaries are not paying their fair share. Would you agree with that statement that they are not paying their fair share?

Mr. **Romoff**. I think that is a fair statement. That is certainly the impression.

Mr. **Flippo**. Can you tell us, are U.S.-owned companies paying any Federal taxes?

Mr. **Romoff**. You are talking to the wrong group. These are all international specialists for the main part.

Mr. **Flippo**. If they are not paying their fair share, their fair share compared to what? I want to get into the record what U.S. companies pay in Federal taxes. Is it shown on the chart over there? Is this displaced on a chart, what U.S. corporations are paying as a percentage of their gross revenues, as a percentage of assets?

Ms. **Halhill**. It shows profitability, what their bottom line is to their assets and their receipts.

Mr. **Flippo**. What ratios or statistics does the Service find most useful to compare taxes paid by U.S.-controlled organizations and foreign controlled organizations. Do you look at their relative ratio of taxes to receipts or to assets or other measures? Any one of our panelists able to share with us what ratios or statistics that you find most useful to compare taxes paid? Apparently those are the most useful ones because that is what you made the chart for, isn't it?

Would someone review that chart for us? The Commissioner left at a good time, didn't he?

Ms. **Morin**. The Commissioner will be back shortly, if you could hold that question.

Chairman **Pickle**. Mr. Flippo, let me interject that we do not have the Commissioner here. He will be here and we can ask those questions specifically of him. I assume that these individuals may not know those figures in a general sense. We will ask the Commissioner these questions.

Mr. **Flippo**. What I was trying——

Mr. **Kamman**. Are you asking with respect to specific companies?

Mr. **Flippo**. In order for you to agree with the statement that foreign owned, foreign controlled U.S. corporations are not paying their fair share, then I assume that we are measuring that against something U.S.-owned, so I am looking at the same database, what are U.S. owned corporations paying, and I think that chart points that out.

Mr. **Kamman**. Yes. A real good statistic is the taxes less deficit paid as a percentage of total receipts, that is sales. When we are looking at specific companies we look at a number of ratios, but that is why we have to find comparables. Those are U.S.-controlled companies, and we compare our foreign controlled subsidiaries of U.S. companies and compare a number of things, including the bottom line net profit.

Mr. **Flippo**. I see the Commissioner has returned.

Mr. **Goldberg**. It makes me nervous, all my allies are leaving.

Mr. **Flippo**. In your absence I believe we established the fact that it is a general assumption of this group that the data demonstrate that foreign owned and controlled corporations are not paying their fair share of taxes. This leads us to the question of compared to what, compared to U.S.-controlled corporations, and so I am asking what data or ratios do you consider most important in measuring how well U.S. corporations are doing?

The question is are U.S. corporations paying their fair share?

Mr. **Goldberg**. Let me apologize. The Tax Court was swearing in a judge, and since I am the respondent in all of their 80,000 cases I felt I had to be there to acknowledge his investiture. He may have all these 482 cases before he is through, so we had to be particularly courteous.

We do not have exactly comparable data for U.S.-based companies since the relevant comparison is to what they are doing abroad. However, we have some occasions, as Mr. Triplett pointed out, where U.S. companies seem to be earning significantly higher returns in their foreign operations, and the Treasury Department has done a study that indicates a similar set of conclusions.

Mr. **Flippo**. I am trying to understand the chart that you have presented us with. If you could help me understand that—whatever database you are using in that chart. I believe you are suggesting in the chart on the right, No. 4, that foreign controlled domestic corporations are paying 0.8 of receipts in taxes.

Mr. **Goldberg**. That is their income as a percentage of their receipts. The taxable income.

Mr. **Flippo**. Not the amount of taxes but their income as a percent of their receipts?

Mr. **Goldberg**. Correct.

Mr. **Flippo**. I suppose you are saying that U.S.-controlled domestic corporations are paying 3.1 percent of theirs?

Mr. **Goldberg**. Right. In other words, they are reporting twice as much or three times as much income. The assumption is that you have a U.S. company in a business and a foreign owned company in the same business. If they are doing about the same kind of business you would expect them over time to make the same kind of income. Some will do better or worse, but when you look at the whole picture, these U.S.-owned companies, if they are making 2.7-percent income on their total receipts you would think the foreign owned companies would be making the same thing, and they are not.

Mr. **Flippo**. I don't want to take up all the time——

Mr. **McGrath**. Would the gentleman yield?

For clarification, Commissioner, the industry supplied a study by Peat, Marwick showing that for the period 1983 to 1986 foreign owned companies paid, they assert, on average a slightly higher effective U.S.-tax rate than all other purely domestic companies when measured as a percentage of assets. I believe chart 3 here would say that is——

Mr. **Shaw**. I would say that is probably, though, based upon the fact that the assets are not here in the United States, particularly the assets——

Mr. **Goldberg**. You are correct. There are several points with respect to that study. One, I believe they excluded loss companies from that calculation. If my colleagues are correct that these companies are generating improper tax losses, then the exclusion of loss companies would not be a fair analysis. Second, as Mr. Shaw pointed out, the report looks at worldwide assets rather than domestic. The report is I think very forthright in saying that there are a number of explanations. One is the startup company phenomena, a second explanation, additional accelerated depreciation, interest charges, and the third would be pricing anomalies.

I understand that Treasury is reviewing that study and will be prepared to comment on Thursday.

Mr. **McGrath**. Could you comment on the effect that the recent decline in the value of the dollar could have as it pertained to this particular phenomenon that we are looking at?

Mr. **Goldberg**. U.S. companies import significant amounts as well, and we have not been presented with any indication that there would be any differences in pattern suggesting that foreign owned companies would be affected any differently than U.S.-owned companies.

Mr. **Flippo**. Let me come back—I apologize for jumping around, maybe we can get a consistent pattern going. Looking at the data, and 1987 has just become available, and the chart that you presented certainly indicates that compared to U.S. corporations, foreign owned U.S. electronics distributors are underpaying their U.S. taxes, would you agree with that?

Mr. **Goldberg**. To the extent you are looking at the aggregate data, that is a conclusion that you would draw. That is all companies, not just the electronics industry. That is everyone.

Mr. **Flippo**. And it is true that even though receipts and assets for foreign owned subsidiaries have increased in recent years, yet the taxes that they have paid have actually decreased, isn't that true?

Mr. **Goldberg**. That is correct.

Mr. **Flippo**. And is this trend for higher receipts and lower taxes particularly true for the electronics industry—Ms. Lewin, I believe you indicated that you thought that it was. I am trying to ascertain if that is the general agreement of IRS.

Mr. **Goldberg**. Mr. Flippo, I am being told the answer to that question is yes. I prefer to provide that information for the record.

[The following was subsequently received:]

MANUFACTURERS OF ELECTRICAL AND ELECTRONIC EQUIPMENT—FOREIGN CONTROLLED CORPORATIONS

[All figures are estimates based on samples—money amounts are in thousands of dollars]

	Tax Years			
	1984	1985	1986	1987
Total number of returns	693	787	971	356
Total receipts	$14,096,743	$15,207,914	$24,409,838	$28,195,192
Net income (less deficit)	$276,753	$36,373	$155,294	$108,466
Total tax (after credits)	$153,145	$124,177	$116,727	$173,855

Mr. **Flippo**. Then the questions comes why is the electronics industry—why is this planned profit practice, what appears to be a planned profit practice more prevalent in the electronics industry than it is in other industries?

Mr. **Goldberg**. I can't answer that question. I don't know.

Mr. **Flippo**. Then I want to direct a question with regard to penalties. You have the authority to apply penalties. We are trying to ascertain whether or not penalties are routinely applied. Have any penalties been applied or collected against these foreign companies, because obviously their taxes——

Mr. **Goldberg**. There are a couple of cases pending where we have asserted penalties. The substantial understatement penalty in particular. Those cases are still in the pipeline and we do not know——

Mr. **Flippo**. Why haven't you applied more penalties? You have authority to assess penalties, do you not?

Mr. **Goldberg**. We do. In specific cases where we believe the penalty is warranted, I expect that we will assert those.

Mr. **Flippo**. Can you tell me of your knowledge of any penalties that have been paid?

Mr. **Goldberg**. I have been advised that at least in a number of pending cases penalties have been asserted. Those cases are not over yet. In terms of penalties paid——

Mr. **Flippo**. So to your knowledge—you don't know that any of them have been paid?

Mr. **Goldberg**. No.

Mr. **Flippo**. We have a situation in which you have the authority to assess the penalties for substantial understatement. There is clearly substantial understatement, and yet no penalties have been successfully applied. And that is what I am trying to understand, is why——

Mr. **Goldberg**. I appreciate and understand your concern. I ought to point out, as you have heard publicly and in executive session, these are extremely difficult cases to make. There are cases where our pricing turns out to be as wrong as the taxpayer's pricing. If we say it is $10 and they say $20 and the court comes in at $15 we are half wrong.

Mr. **Flippo**. I want to find out if you need greater sanctions and what are they?

Mr. **Goldberg**. That is a question worth looking at. All the penalties today require that we prove the guy is a bad guy.

Mr. **Flippo**. We want you to tell us what further sanctions you need to stop this outrage of inequity. One other area——

Mr. **Shaw**. Could I jump in, because I believe this is the main responsibility of this committee, that is to possibly recommend areas of needed legislation, and what we should be looking at. We have a clear example, and I have learned a lot during these particular hearings.

One is I have learned of the existence of a blue book which compares various types of electronic gear. The blue book, for instance, shows that VCR's distributed by foreign subsidiaries are identical to VCR's marketed by U.S. companies like RCA and Magnavox. We know all VCR's are manufactured outside the United States, mostly in Japan, which has led the industry in this area.

How are these blue books used in the examination by the IRS?

Mr. **Chmiel**. I was one of the first people to use the blue book. As I mentioned in my statement, one of the problems that we have in obtaining comparables is getting that information—the best place would be to get it from the factory or the offshore manufacturer. If we don't, we then go to trade publications and find out that a common manufacturer has been making the product.

Once you get that data and you find out you have your third party, how do we compare and make adjustments for identical units or make them even similar. This blue book was published by a company, an independent firm I think in Colorado. I would assume what they did is took the units apart and found out that the chassis in particular, VCR's were very similar. This blue book was one tool to compare the units, telling me that the U.S. distributor and the unrelated distributors were purchasing a model that was similar for comparison.

Mr. **Shaw**. And they are purchasing it for less?

Mr. **Chmiel**. Yes.

Mr. **Shaw**. I want to walk through that for a moment, because I don't want that point to be lost.

Mr. **McGrath**. Would you yield on that?

Mr. **Shaw**. Yes.

Mr. **McGrath**. You said the word "similar." are they exactly the same?

Mr. **Chmiel**. This was the purpose of this blue book. What it did was the way it was written in the blue book, it said that the models were similar. Much more work had to be done to make sure that these products were identical.

Mr. **McGrath**. But they are?

Mr. **Chmiel**. Yes. And in the event that they were not identical, provide—the regulations provide that we can make adjustments. There could be feature differences, but again we have to rely on the factory to quantify these differences.

Mr. **Shaw**. I want to walk through the example. When a U.S.-owned manufacturer buys the VCR for less, then he sells it for the same price as the VCR manufacturer trade name VCR sells for, he makes a profit. But then if the wholly-owned foreign subsidiary brings it in at a higher price, they sell it and they can show a loss, because by bringing it in at a higher price they have increased the money that goes back to the manufacturer.

That is where the income goes, Uncle Sam and the U.S. taxpayers are the loser and they are showing that they are not making any money. If business was any better particularly with Japanese firms, I believe Japan would probably drown in red ink.

Mr. **Dorgan**. Would the gentleman yield? I am interested in pursuing that approach with the Commissioner.

Do we have any provisions in tax treaties that allow the IRS to determine whether the corporations are coming back to the country of domicile or they are telling the home country that that is apportionable income made in the United States?

Mr. **Goldberg**. We have exchange of information agreements that would give us that information. We also try to develop that information in a specific taxpayer case. You need to know what is going on at both ends of the deal, and it is very difficult for us to get that information from the taxpayer.

Mr. DORGAN. I am asking about tax treaties with the host countries. You say that you have some of the information. My guess is that classic transfer pricing would allow the taxpayer to tell two countries separate things, they would tell this country they made no money here and they would tell the home country that they made the money in this country, and it would be both ways in both filings.

Do you have a way to get the information about what kind of income they are calling that?

Mr. LAINOFF. Provisions of tax treaties permit us to request information. It is true that not every treaty partner is as cooperative as we would like, so there are situations where we have made requests for information and have not received as much information back as we would prefer.

In addition, there are situations, for example, where if the transaction doesn't go directly back to the home country but it goes to a intermediary stop along the way, if there is a trading company in Singapore for instance, it is difficult for both countries to figure out what is going on in that third country operation.

Mr. DORGAN. It is not difficult, though, to understand from a few steps away what is happening. What is happening is massive tax avoidance because they are pricing profits out of this country. My guess is that they are not paying taxes on those profits anywhere. What mechanisms can be developed to make sure it is taxed here or abroad, preferably here because here is where the transaction occurs? Is there a mechanism at this time to make sure that is the case?

Mr. BERGHERM. There is a mechanism under the information exchange provision of the tax treaties which could be applicable under the circumstance you described. One is simultaneous examination. In that process the two countries involved, we and our treaty partner, would identify an affiliated corporate group that we are each mutually interested in and we would each on a coordinated timing examine the entities within our respective jurisdictions in that group.

Mr. DORGAN. Is that done?

Mr. BERGHERM. Yes.

Mr. DORGAN. How frequently?

Mr. BERGHERM. Over the course of the general period that we have been discussing here today, approximately 50 taxpayers.

Now the other mechanism is an industrywide conference. On a bilateral or a multilateral basis among our treaty partners, we would identify a particular industry and bring together the people in our tax administrations that are involved with the examination of that industry and provide the mechanism for the exchange of information among the multilateral or bilateral group. There are certain industries that we have done this in. Electronics is one, the banking industry is another, petroleum is another.

So those mechanisms are facilitated by the tax treaties.

Mr. DORGAN. But apparently not sufficient to respond to this kind of problem. We are talking about what appears to be systematic program tax avoidance, and you are suggesting that there are mechanisms to engage in the sort of thing I discussed; and maybe we have a hundred of them over a decade or so.

We are trying to determine if this appears to be that kind of systematic tax avoidance scheme, and I have a manual in which some people put out information on how to beat you on this. Are there devices that you have that you are able to penetrate these schemes? The answer appears to be not the kind of devices that are sufficient to really cover the waterfront and close down that kind of tax compliance problem.

Ms. LEWIN. A couple of comments. To get information back through a treaty country, if you get it in a year it would be lightning speed. Two or 3 years is probably normal.

Mr. FLIPPO. I might follow up on what the gentleman is talking about there.

We have this problem. What we want to know, is 482 sufficient in its present from to defeat this problem, Commissioner?

Mr. GOLDBERG. In my judgment, Mr. Flippo, 482 is adequate if the Congress of the United States, the administration, both sides, are willing to make the long-term investment in tax administration. I am giving you a list of things we ought to do.

My answer is yes, some of the proposed legislation is critically important.

I think if you do all of these things——

Chairman PICKLE. I appreciate your statement.

We accept it on its face. It is generally true we can do these things.

The fact of the matter is we are not doing a good enough job. The 12 people from the field, the men and women you have out in the country, testified today that there is a clear pattern of these foreign subsidiaries avoiding taxes. There is a clear indication.

And you say what proof do you have?

The proof is looking at the income tax returns. What are they paying?

When they are making $1 billion and pay no tax, that almost speaks for itself.

When you say we can do this if we make a long commitment, I would ask if the IRS has made a long commitment? Has the administration asked for it?

You indicated this morning there was an increase of personnel directed to this problem. I was impressed with that.

But, Mr. Flippo looked at some of the figures about the requests you made over a period of 10 years. Generally, the Congress appropriated more money nearly every year than you asked for.

I accept your statement that, yes, we can do a lot better on this subject if the Congress and the Internal Revenue Service makes a long-term commitment. I don't know that I would get all excited about it because it is too obvious on its face. You have not done it.

Mr. GOLDBERG. These folks can answer better than I. I believe this agency identified this issue, called this issue to the attention of the Congress, the American public, is pursuing it.

I am not going to say the IRS budgets during the last several years have been adequate. I have stated publicly and on the record they have not been adequate. The 1991 budget is a step in the right direction.

If there are other ways to get at it, if no-fault penalties are a way to get at it, if different kinds of access to information, that kind of legislation will help us do a better job in getting information, I think we have to pursue it.

You have heard these folks out there doing the work tell you that there are serious compliance problems. I believe them. I think they are right.

Mr. FLIPPO. I agree. When we ask, as the chairman does, why do we have this problem? If 482 is adequate to deal with the problem, why are we having this kind of problem.

It did strike me on page 2. I want you to know that I personally appreciate the testimony of every witness we have had. It has been very helpful to me.

But on page 2 of your testimony, Mr. Commissioner, you point out that we failed to provide those working in the international area with all the tools and the training that they need to do the job.

You also point out that the emphasis on IRS programs that generate short-term, quick-hit revenues has caused extensive growth in these areas which tend to affect middle-income individuals and small business taxpayers relative to activities such as transfer pricing.

It is a rather serious statement.

What I am trying to understand then is why has IRS concentrated on the quick-hit short-term revenues that seems to affect—why have they gone after middle-income individuals and small business taxpayers?

Mr. GOLDBERG. Mr. Flippo, we are trying as best we can to change that direction. But the plain fact is that when you have annual budgetary targets that say you have got to raise this amount of money this year, if you send a computer notice to an individual, you are going to get the money this year.

If you do a 482 examination, you are not going to get the money for 5 or 6 years.

Mr. FLIPPO. Who made the judgment to go after middle-income taxpayers?

Mr. GOLDBERG. In my view, I think all of us are responsible and I think all of us ought to change it.

Mr. FLIPPO. I have the budget request of Congress for every year since 1981. Every year since 1981 the Congress has appropriated more money than it has been requested to appropriate from the budget request.

And in every case this Subcommittee on Oversight has sent letters of support requesting even further appropriations be granted. You can't say that this committee has not supported the Internal Revenue Service in its efforts to have sufficient funds to deal with the problem.

You cannot say that.

Mr. GOLDBERG. I believe that this subcommittee has done more to improve tax administration than anyone else around. I take my hat off to you for it. Now let's see what happens in 1991.

Mr. FLIPPO. Again, in 1991 this committee, I believe, I yield to the chairman to say what the committee is going to do, but I am just simply saying to you when you say that the Service has gone after middle-income individuals and small business taxpayers for various and sundry reasons, that you cannot lay that at the door of this committee.

Mr. GOLDBERG. I am trying to be honest with you folks about something that bothers me as the Commissioner of Internal Revenue and that I believe we ought to change, and I think we are changing it.

Mr. FLIPPO. This committee is prepared to support whatever tools are necessary to get this job done, but the job is not getting done at the present time apparently from the data. Yet, I am confused because you tell me 482 is adequate.

Mr. GOLDBERG. One of the things that I find, if you look at those charts, for example, they show you a pattern from 1983 through 1987. You have heard these international examiners and economists talk about the fact that they are still dealing with tax cases from 1979.

I think that clearly this is an area that requires attention, it requires more investment on our part. We have got to do a better job.

Mr. Heck testified that we do not coordinate our efforts as well as we should. We can clearly do better. These cases take a long time.

Mr. FLIPPO. Thank you for your response.

I do want to again thank every person who has testified. I think the testimony has been very helpful. We must find some way to move this forward rather than waiting from 1979. That is intolerable.

It is also intolerable that we have corporations, be they U.S. or foreign, that are not paying their fair share of the taxes. It is also intolerable that we seem to have plans to avoid these taxes that are planned programs that are successful and have been successful for many years in avoiding U.S. taxes, their fair share.

Mr. SHAW. Mr. Chairman.

Chairman PICKLE. Mr. Shaw.

Mr. SHAW. In the closed hearings we talked to the Commissioner about something I would like to touch on here. That is compliance with the competitive acquisition procedures of the Federal Property and Administrative Services Act as amended by the Competition in Contracting Act when the IRS requires extra witnesses services for litigation.

Does that only affect the hiring of expert witnesses? Does it affect your retaining outside counsel to go after some of these cases so we can bring the backlog up to date and get on with the assessment of some of the deficiencies that are owned to the Federal Government?

Mr. GOLDBERG. It would affect any outside support whether economists, lawyers, professors, translation firms. It affects all of the things we need to do to work these cases.

Mr. SHAW. Do you believe since the IRS has been probably the undisputed greatest teacher of tax litigators in the private sector, that we go back and contract with some of them to represent us particularly on some of these big buck cases in order to reduce this load and get on with this?

Mr. GOLDBERG. I will permit my lawyers to answer that question.

Mr. LAINOFF. One point in response to that. We would have to find some law firm which presumably is willing to give up working for anybody else. One of the things we found, for example, in trying to hire experts from accounting firms or economists who work for accounting firms is they don't particularly want to have us as a client because they are afraid that their regular corporate clients would be scared off because they are working for the other side.

Whatever merits there might be in the idea, we would be in that position.

Mr. SHAW. Obviously that needs some thinking through. There is something.

You know, the problem that I see right now, and the chairman and Mr. Flippo articulated the point very clearly, is that we need to get more people in this area and all the witnesses we have conferred with in executive session and open hearing have been uniform in making the point, we are outmanned.

We are doing the best we can, but there is just so much that we can do with the staff that we have.

If we were to give you all the money in the world today, it would take you 2 or 3 years to get them up to snuff and get them trained so they are competent to go in the field and do these audits and examinations.

I notice everybody is using the word tax avoidance. I would prefer to say "tax evasion" in many of these cases.

I believe there is no question, but there is probably massive fraud by many of these foreign companies that are making absolute fortunes within the United States and paying absolutely zero dollars in income tax.

I have a point I want to make. Then I have a question.

The point is this is not only skinning the U.S. taxpayer but adding to our deficit by not contributing anything back to the United States where these companies are making huge fortunes. It is also an unfair competitive advantage that is given to these foreign manufacturers who don't have to pay taxes.

I will guarantee that if you take any one of the major auto dealers in the United States today and you tell them they don't have to pay taxes for 10 years, they will end up number one. You can't compete with people that are competing with you on the same street but aren't paying any taxes. That, I believe, is an absolute tragedy.

It is fleecing the American workers out of their jobs. It is a terrible situation we are allowing to exist. It is a terrible injustice we are giving to the American corporations who are paying their taxes.

The question I have because the situation is so serious and so massive, why don't we go after someone for indictments? Why don't we send somebody to jail? If it was someone in General Motors doing it, he would be under the jail.

Mr. MILANO. I would like to say one thing regarding the penalties dealing with these cases we are dealing with. The majority of these cases are still in the pipeline, still being examined.

I just want to highlight something dealing with penalties and trying to close the loophole. A lot of these cases are still under examination right now. All I am trying to say is, sir, is that regarding these substantial understatement penalties in these transfer pricing cases, they will be asserted by field personnel provided adequate disclosure on the tax returns has not been done by the representatives dealing with these tax returns.

Adequate disclosure, saying there may be a potential transfer pricing problem with this company. If adequate disclosure is not made and if we find we have a transfer pricing problem with any of the companies we are dealing with, we will apply 6661, the substantial understatement penalty, to deter them from this transfer pricing problem.

I agree with you, you didn't address the penalty question.

Mr. **Shaw**. We have not addressed the question of criminal penalties. That is what my question was.

Mr. **Goldberg**. We have been notably less than successful in our efforts to assert civil fraud penalties, much less criminal penalties, against large corporate taxpayers.

Mr. **Shaw**. The average American taxpayer pays his taxes out of fear. This just doesn't seem to exist with these companies who are uniformly flipping their noses at the IRS.

Mr. **Kamman**. Could I make two points?

First of all on throwing money at the Internal Revenue Service. It doesn't do you any good to give us more hiring authority if you don't pay us enough when we are here. I think you have to do something about Federal pay.

Then I was going to deal with——

Mr. **Flippo**. I make the point here. I believe Mr. Lainoff, you made the statement that the accounting firms, the big six or the big eight accounting firms didn't want to be a client, or didn't want to work with you.

Don't let me misstate that. What was your statement?

Mr. **Lainoff**. We have had difficulty in obtaining the services of those types of people.

Mr. **Flippo**. Do you presently have any of the big six retained?

Mr. **Triplett**. Mr. Flippo, to put the question in context, we have not at this time engaged outside counsel to try these cases.

With respect to the accounting firms, I have personally asked a number of accounting firms. To my knowledge, only one accounting firm of the big six has expressed any willingness to be our experts in these cases.

Mr. **Flippo**. If it is so difficult, why has the Service downgraded the salaries for the economists and accountants in this? Is that true?

Is that true?

Mr. **Milano**. The economists grades were downgraded. Mr. Zemsky can speak to those. The accountants grades were not downgraded.

Attorneys have been upgraded to the extent we can't add more 15's and other things in the field. There has been an effort to get the grades up in the field with the attorneys and others.

Mr. **Flippo**. If it is so hard to get anybody to do this work, why are we downgrading? That doesn't make sense to me.

Mr. **Goldberg**. That is a very good question.

I think it is important for all of us to remember that this is a very large organization.

We are not talking 30 economists. You are talking 30 economists, you are talking thousands of revenue agents, you are talking folks who do money laundering and drug crime work and taxpayer service work. I believe these folks should have their pay raised.

It is going to cost money. I think that you folks, as I say, have done more to make the system work than anybody else around, but I think at some point we have to be realistic. We have got to pay for it. I think we ought to. I think we are making a step in the right direction.

Mr. **Flippo**. Mr. Commissioner, it doesn't make sense to be downgrading these positions. We heard testimony from many people here that we are losing people. I hope you look at that policy.

Mr. **Goldberg**. I think the point you are making that we control some of this ourselves is absolutely right. I think we need to do a better job of it.

Chairman **Pickle**. Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman.

Let me just add to that dialog regarding compliance. All of you have outlined what seems to be a scheme of tax avoidance under section 482.

I just wonder what is being done.

As I understand it, the tax return preparers are not supposed to take a position on a tax return if there is no realistic possibility of being sustained on the merits. Are the attorneys and the accountants who habitually prepare tax returns with inflated tax transfer pricing normally referred to the Director of Practice for possible suspension or disbarment from IRS practice?

Mr. **Goldberg**. We are not aware of any referrals in this area, Mr. McGrath. I think that, again, I hate to be a broken record here, but I think if you listen to the reality of how difficult these cases are to make, how——

Mr. **McGrath**. I understand that but you have a long history here. Some of your cases go back to 1979. Some cases, some of those cases have been successfully completed.

Yet, the practice seemingly continues by virtue of the charts that you have shown us in terms of the tax payments as a percentage of their assets going down. I just wonder whether or not there are people out there who are preparing similar kinds of returns as a longstanding practice and what the Service is doing about that?

Ms. **Lewin**. Mr. McGrath, if I might answer that, in my history since 1974, with the international enforcement program, penalties that we may have assessed against taxpayers or tax preparers, as that case moves up through the system, the system itself will abate that penalty the first thing around against the preparer and/or against the taxpayer in appeals or in the court.

Mr. **McGrath**. Why?

Ms. **Lewin**. I don't know why, other than based upon if penalties surface, that is the first thing that must be reported and disclosed on a financial reporting system of those corporations. That is the first thing that hits the shareholders. That is the taxpayers and tax preparers, they want those penalties done away with so that disclosure is not made to the general public, which is their shareholders.

Mr. **McGrath**. Mr. Romoff and Mr. Lowry, I would like to direct my questions to you as you seem to have the most experience in automobile cases. Some of the testimony that both of you have given us, shows that other than insurance, freight, shipping and other costs, that in some cases, in a lot of cases foreign manufactures sell in their countries at a substantially reduced price than the price which they sell to their foreign-owned subsidiaries and also at a substantially reduced price to domestic distributors in the United States.

What do they tell you when you show them that the FOB to a foreign-owned subsidiary is substantially higher than the FOB to some U.S.-owned distributor, but they are selling the exact same product?

What do they tell you?

Mr. **Lowry**. To my knowledge, to date we have not received a meaningful response to either ~~one of~~ those questions, from either accounting firm or the taxpayers.

Mr. **Romoff**. In the cases that we worked, there were no unrelated sales. They sold all of their production to the U.S.-controlled subsidiaries.

I would like to address a broader problem if I may, and I have been around a little bit. I think from a Service standpoint, we just are not efficient even though we have been in this area for a long, a long time, in the 482 area.

I have to say that you are talking about penalties. From my experience, I feel very fortunate if we can get a 482 issue sustained notwithstanding the penalty. I don't think that we are as efficient as we could be. I don't think we made as much of a commitment that perhaps we should have in this particular area.

Again, we have a torturous road with regard to setting up and maintaining a 482 case. It is not an easy thing to do. Some fraud cases that have nothing to do with 482 are easier to make than a 482 case, in my opinion. That is part of the problem. It is a torturous road that we have to take.

And, we are not as efficient as we could be in this 482 area. There is no question about that.

Mr. **McGrath**. Mr. Romoff, in a prior conversation you had mentioned that you think a solution to the problem would be to require those companies, those foreign companies, to submit as an addendum to their tax return how they achieved their transfer price.

Is that something that would be difficult to enact or something that the IRS would be prepared to support?

Mr. **Lainoff**. Mr. McGrath, that actually was the recommendation that was made in the Treasury/IRS white paper on 482 back in 1988. It is something that does not require legislation. We are in the process of working on proposed regulations under the white paper. That is one of the things that we are considering.

Mr. **McGrath**. It seems to me what is happening here is that the length of these cases, in some cases, mitigates against your ability to come to a conclusion. One of the things that really hurts is the lack of information that you have and in some cases the lack of availability of the information from the foreign manufacturer.

It seems to me that if you did this, if this information were readily available on a return and some sort of time constraint then the cases could be closed within that purview.

I am wondering whether or not you could tell me how Mr. Lowry, it was that there was no explanation between the FOB prices to their own company as opposed to a U.S. domestic company. A lot of these companies are making billions of dollars in gross receipts.

Yet, they pay little or no Federal income taxes. I wonder if you can give us examples of how an automobile distributor who has billions of dollars in gross receipts can pay no income taxes? What mechanisms do they use other than the obvious increase in the FOB price?

Mr. LOWRY. What general mechanisms do they use to inflate the price coming into the United States?

Mr. MCGRATH. Right, other than the increased FOB price from their manufacturer?

Mr. LOWRY. One example which comes to my mind is that the trading company in the foreign country would go to their respective bank in the foreign country, borrow money on the funds that are to be paid by the U.S. entity and for that advance of funds by that foreign bank, that foreign bank in accordance with lending money will charge interest. Then they, from borrowing the money from the normal payment date the interest that is normally charged to that foreign entity is passed on to the U.S. subsidy and are paid by the U.S. subsidiary. That is one way of doing it.

Mr. MCGRATH. Do you find that the costs of shipping insurance and freight are consistent between a foreign loan subsidiary as opposed to a domestic distributor? Are there inflated prices there?

Mr. LOWRY. Yes, sir.

We have found vehicles that have been delivered to the same port on the same ship on the same day, vehicles delivered to unrelated importers is lower than the price charged to the controlled foreign importers.

Mr. MCGRATH. You are shaking your head, Ms. Lewin.

Ms. LEWIN. Yes, that is basically information obtained through Customs. That is true. You have vehicles coming off the same ships, same port.

Mr. MCGRATH. Going to different distributors?

Ms. LEWIN. One going to a controlled U.S. distributor and one going to an uncontrolled and the price is substantially different.

Mr. MCGRATH. How do the companies or their representatives frustrate or delay the examination process? Can you give us details as to how that may happen?

Mr. LEWIN. One real way, we normally issue what we call IDR's, information document request, in the beginning of the examination.

It may be as much as 6 months, a year or longer before we receive any part of our request. We make follow-up requests. This is a repeated process.

In my opinion, it is a tactic used by the taxpayers and also the accounting firm. As long as they can track it out, the more difficult they make it for us.

The other part of it is the other side of the coin, the documents that would give us the whole picture quite often are in the foreign country. When we request those documents, as we found in the Toyota case, they have been destroyed.

What we would like to have is those documents timely available to us and for our review. As you said, have some form of disclosure as to what kind of pricing procedures they use.

Mr. McGRATH. As part of that question, have any of you ever been, or is there any evidence to put it differently, of improper pressure from any of the agencies in our Government or a foreign government to resolve these kinds of cases in a more timely manner to the satisfaction of a company than what ordinarily might occur?

Mr. ROMOFF. I guess there were some indications from the foreign governments protesting the actions that we took.

Mr. McGRATH. Directly to the IRS?

Mr. ROMOFF. That were made to the State Department. Some indications from the State Department we got from Treasury wanting to know what we were doing.

Mr. McGRATH. Hindsight is always 20/20. Is there any way that looking back at all of those cases that you have been dealing with over the years, is that you can arrive at some rough justice and expedite the resolution of some of the backlog that you presently have of section 482 cases?

Mr. ROMOFF. I would say we just make a bigger commitment to becoming more efficient in this area and be a little bit more patient. Being patient and getting the expertise in the long run will pay off. That is what I suggest we do. In the long run we will become more efficient and resolve these problems.

Mr. McGRATH. Your idea is that the best way to become efficient is to get these cases adjudicated as quickly as possible and the best way for you is to have the information available from the outset on the return?

Mr. ROMOFF. That is absolutely essential in my opinion.

Mr. McGRATH. I really hope that if that is the attitude among the hierarchy of the IRS and that is not something that must be enacted legislatively then perhaps through some sort of regulation this might be able to be expedited. It seems to me to be a consensus approach to the expeditious resolution of some of these outstanding cases.

If it needs to be done on a basis that goes back a few years, perhaps it could be added to the bill that is being sponsored by the chairman of the committee.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. McGrath.

Now, Commissioner, I know it is running late. Deputy Commissioner Lane has been waiting all day for you to finish so he could testify. I only have a few questions for you. I will submit a lot in writing.

Mr. GOLDBERG. Tonight is my wedding anniversary and my wife is planning to submit written questions as well.

Chairman PICKLE. Well, maybe I had better keep you here for some time them.

I have here, Mr. Commissioner, an example of a facsimile to a Japanese parent company from a U.S. subsidiary. The Internal Revenue Service obtained this facsimile through the U.S. subsidiary and had it translated into English from Japanese.

Here is a copy of the facsimile. In this facsimile the Japanese manufacturer told the U.S. company that it was making too much profit in the United States and subsequently to increase the manufacturer's earnings in Japan and it proposed raising the transfer price of the car to the United States.

[The following was subsequently received:]

(TRANSLATION)

[redacted]
[redacted]-(illegible)

[redacted] [redacted]

[redacted]
To: [redacted]
Date: Dec. 28. '82.
From: [redacted]

Subject: Price of 83 Models (file)

Re 12/28 fax from Overseas Sales Division.

The kind of letter which one doesn't care to read so close to the year's end or that something which one has always been fearing might happen, has finally arrived.

[redacted] announcement that it was expecting increased earnings for next term (or this term, more correctly speaking), gives us the impression that it is determined to maximize profits in the U.S. market. Apparently, [redacted] has a strong aversion to the [redacted] companies making excessive profits. This was expressed quite clearly by Mr. [redacted] who told us quite bluntly that the biggest problem with [redacted] is that ~~we are making too much~~ profit. Mr. [redacted] also relayed to us a message from Mr. [redacted] [redacted] that he wanted us to sell more trucks. Any way, frankly speaking, we cannot understand why they have sent us this long fax.

In the past one year, we have been screaming at them every time they wanted to raise the prices. Is this a sort of pre-emptive strike to discourage our attempt to obtain a price reduction? Or are they proposing it to [redacted] importers? I have not had a chance to talk with [redacted] In the meantime, I am still wondering how I should respond. If you have any suggestions, please let me know.

In other woreds, they are telling us that they will not talk about any price reduction and that we should put up with the deficit and spend money for sales promotion of trucks.

Should we just meekly do what we are told to do without complaining or should we assert what we believe to be right? Please give us your guidance on this point.

At least, we would like to reserve to ourselves the right to raise the retail price to maintain our profitability.

We plan to call on [redacted] in early March, the reason being:

1) That our '82 earnings and the '83 January earnings are expected to be positive, which make our presentations less convincing. Besides, our presentation materials won't be ready until after the end of January.

2) Both sides are likely to be very busy.

3) It may be better to go in March with the deficit figures of February in hand.

Your comments are invited.

We would like to take this opportunity to thank you for your cooperation throughout the year and wish you a happy New Year. Say hello to all.

Sincerely,

P.S. The seal on the fax is that of Mr. [redacted] or of Mr. [redacted] It's illegible.

Chairman PICKLE. Have you seen this facsimile? Are you familiar with it? Mr. Lainoff, have you seen it?

Mr. LAINOFF. Yes, sir.

Chairman PICKLE. My question to any of you, do you have access to these kinds of faxes from foreign owned subsidiaries?

Mr. LOWRY. As a general rule, sir, no we do not.

Chairman PICKLE. Was this just happenstance? We got it from the file. You had it translated twice. Once by the company they said it did not mean anything but you got your own translator and then you found out the parent company was saying its subsidiary was making too much money in the United States.

Mr. LOWRY. This was not happenstance. At the onset to get those records we made a systematic request to obtain this internal communication. My previous experiences working for the outside, and I know at least these type of documents do exist. I have made systematic requests for these type of documents.

Chairman PICKLE. But you have no access to these facsimilies, letters or instructions that might be coming other than happenstance, right?

Mr. KAMMAN. They did turn it over. It is a very extraordinary circumstance.

Chairman PICKLE. It must have been. Actually, isn't it a fact though that it is difficult to get this information and that many of the records are in foreign languages and located in Japan, Korea, West Germany, or some other place? So that makes your job more difficult.

Mr. LOWRY. Yes, sir, that is correct.

Chairman PICKLE. Now, Mr. Lainoff, you seem to be having a good time here today. With respect to your duties do you advise the Commissioner? Are you his lawyer? He claims you, do you claim him?

Mr. LAINOFF. With great pleasure. Mr. Chairman, I am in charge of the international organization within the Office of Chief Counsel.

Chairman PICKLE. Do you advise the Commissioner on these international cases?

Mr. LAINOFF. With respect to the international cases there are a number of different functions within chief counsel. I have general authority and responsibility over the program in general.

However, the specific cases are handled by the people like Mr. Kamman out in the field.

Chairman PICKLE. As the chief counsel for the International Division, each time one of these cases is up for consideration, you have an input, do you not generally?

Mr. LAINOFF. That is right. We work very closely with the field.

Chairman PICKLE. When a settlement is made I assume it is with your concurrence as well as the field office?

Mr. LAINOFF. Not always. The responsibility for handling the particular cases as an organizational manner rests with the field office.

Chairman PICKLE. I notice that the percentage of cases sustained in appeals in 1987 approximated 24 cents on the dollar, in essence. In 1988 it was 27 cents. It got up to 35 cents in 1989. Is that generally correct?

Mr. **Lainoff**. Mr. Chairman, I do not handle the appeals organization. That is a separate part.

Chairman **Pickle**. I am trying to find out, is it your decision finally to settle these cases? Are these low percentage achievements out in the field?

Mr. **Lainoff**. That is the responsibility of the Office of Appeals.

Chairman **Pickle**. It is a relatively small amount of money, 10 to 35 cents on the dollar. The fellow in the field makes that decision?

Mr. **Kamman**. That decision is made in the field. I do not have settlement authority on the cases I settle. I would not settle like that without coordinating with Mr. Lainoff and Mr. Triplett's office without discussing it, without their recommendation.

I have not ever settled a 482 case. They are in the pipeline. There are cases from 1970 through 1980 moving toward litigation.

Mr. **Lainoff**. Before the case gets to chief counsel there is an administrative appeals process which are the statistics that you were just referring to. Those are the cases that Mr. Kamman does not yet have.

Chairman **Pickle**. As a general proposition, appeals settles these cases for 27 to 28 cents on the dollar. But that is just the start of the process, isn't it? You have litigation after that, correct?

Mr. **Lainoff**. Yes, in the case that——

Chairman **Pickle**. That means the percentage goes down, does it not? Does anybody know?

Mr. **Lainoff**. There are very few cases that have gone through the full litigation process. There are a lot docketed right now.

Chairman **Pickle**. Let's touch on that one. Mr. Chmiel or one of you said that the IRS really has a good record, not as bad as it looks because a lot of these cases are in the pipeline and have not been settled. They have been in the pipeline for 5 or 10 years or more until the limitations run out.

I don't think it is an explanation to say we really cannot give you any definitive answer because these cases are not settled. In effect they could have been settled but you don't have the manpower or in effect you just don't attempt to prolong them because you don't get a settlement within that period of time.

Is that incorrect?

Mr. **Goldberg**. Mr. Chairman, the way it works is you have the taxpayer and the examination function examines the taxpayer. If it is a big company, part of a large audit with domestic issues, that can take 5 or 6 years to get done. Then that goes into the appeals function and the appeals function will settle that case if it can.

As you pointed out, the sustention rate in those settlements runs 30 to 40 percent depending on the taxpayer and the tax year. The appeals officer settles the case based on the records coming from exam and whatever the taxpayer chooses to tell the appeals office.

Mr. **Flippo**. Isn't it true that these companies are simply playing the audit lottery? I am looking at a memo that I am sure you have had available to you that states that a company's own analyst estimates that their gross profit margins are clearly inadequate and if examined by IRS the company could lose $40 million in taxes.

The memo goes on to state that this is a conservative estimate. Don't these companies just play the audit lottery waiting to be caught by the IRS?

Mr. GOLDBERG. Mr. Flippo, I am sure some of them do.

As you have heard today others pay their fair share. Undoubtedly some of what you say this is going on, is going on.

Mr. FLIPPO. Don't you suppose that they even calculate their exposure to IRS examinations as part of their planning strategy?

Mr. LOWRY. Yes, that is true.

Mr. FLIPPO. So they play the lottery. If you happen to get caught, you go on and settle for what, 25 cents on the dollar, is that what it is, something like that? That is a pretty good deal.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Commissioner, would you furnish for the committee later some facts and information about the number of cases under appeal, what happens after litigation and in fact how much we settle on the dollar in many of these cases. You can get at that information, can you not?

Mr. GOLDBERG. Yes, sir.

[The information follows:]

Data and Analysis of the
Sustention Rate of IRC Section 482 Cases

Appeals Sustention Rates:

Fiscal Year:	1989	1988	1987
Proposed Adjustment	$1,224,686,318	$1,991,404,999	$563,716,721
Adjustment Sustained By Appeals	$506,537,594	$542,251,631	$133,669,236
Percentage Sustained	41%	27%	24%

Notes

1) As of March 31, 1990, there were 242 work units (cases) in Appeals with section 482 issues, and the total proposed adjustment for these issues was over $8.6 billion.

2) The above amounts come from an analysis of data recorded by Appeals officers. The collection of this data was not intended to be a source of information for sustention rate analysis. This data should not be quoted as exact amounts. However, it represents the best available information for the data you requested.

3) The "Proposed Adjustment" represents the amount of section 482 adjustments proposed by Examination on work units (cases) closed by Appeals during the fiscal year.

Chairman PICKLE. Please do, then.

Commissioner, your people testified today that existing procedures are badly abused and the foreign corporations are paying very little tax and even when they do initially pay a little tax, the next year or two there is a writeoff through loss carrybacks. The record shows that the $600 to $700 billion of sales resulted in very little tax to the American Government.

In the lawyers' terms that is res ipsa loquitur, that speaks for itself. We know we are not adequately carrying out our tax laws and requirements. There are lot of reasons for it. This committee has to assume as much responsibility as you down at the table.

There must be a commitment on our part and your part and the administration that we are going to do something about this. The investigation that the staff has completed on this in my judgment is the most thorough and complete tax examination and review that has been conducted by the Congress in a long time, perhaps ever.

We are just starting because we think that this entire question has to be examined and it has to be magnified and the American people have to understand it. American business and foreign business have to understand that everyone should pay their fair taxes. If I would ask you what is a foreign corporation's fair share of taxes, how would you answer me?

Mr. GOLDBERG. They ought to pay what they owe.

Chairman PICKLE. When they have sales upward into the $600 million and then in effect don't pay taxes, you have to say essentially they are not paying their fair share of taxes. This may work in reverse in outbound cases. We cannot be sanctimonious about it. But it is a serious question on an international basis not just in the United States.

I think we must look at it. But you do admit that there is no question in your mind that there is a serious tax compliance problem involving the use of transfer pricing?

Mr. GOLDBERG. That is correct.

Chairman PICKLE. Your IRS agents described cases involving adjustments from over $1 billion to "no change." How much of the Federal revenue is lost annually due to noncompliance by foreign-owned subsidiaries overall and 482 specifically?

Mr. GOLDBERG. We do not have that information, Mr. Chairman.

Chairman PICKLE. I would like to squeeze a little more information out of you then. This morning I asked you if it was as much as $13 billion. You said it might be. I read it could go from $13 up to $30 or $40 billion. It has been claimed by another group that it was upwards of $50 billion possibly.

Generally, if it was no more than $15 to $20 billion, that is an enormous amount of money we are not collecting. Do you dispute those figures or would you say you don't know?

Mr. GOLDBERG. My personal judgment is that that $13 to $20, $15 billion range is excessive. I don't think it is that high You are going to measure it with a B in front of it, if it is $1 or $2 or $3 billion, it is a big number.

When you throw out numbers like $50 billion that is a big number.

Chairman PICKLE. Do you have an overall compliance rate by U.S. companies? What is the tax-compliance rate?

Mr. GOLDBERG. We don't break the information down between U.S. companies and foreign owned. So we do not have that information.

Mr. MCGRATH. What are the effective tax rates of U.S. companies in similar businesses?

Mr. GOLDBERG. You need to measure it relatively. If they have a dollar of taxable income, they are each going to pay 34 cents.

Mr. MCGRATH. Given all the tax deductions that are available to a company——

Mr. GOLDBERG. Measured as a percentage of assets and gross sales the tax rate, when you get down to taxable income, the U.S. companies are paying twice as much.

Mr. MCGRATH. Couldn't you take the adjusted gross receipts of a domestic company and apply the effective rate and come up with a certain amount of expected revenue? Is that too hard or too simple?

Mr. GOLDBERG. I will have to get our research folks to run through that analysis.

Mr. MCGRATH. Is it possible to take whatever the gross receipts are of a foreign company and then deduct everything that is logical to deduct and come up with a certain amount of taxable income that might be available? Couldn't you equate the two in some way?

Mr. GOLDBERG. You could go through that exercise. You could say that U.S. companies seem to be earning 3 percent of sales so let's apply 3 percent to the sales of the foreign-owned companies. If that is what they were reporting as taxable income, how much income would they be reporting. You could go through that kind of an exercise.

Mr. MCGRATH. If you did that kind of an exercise wouldn't it be possible to come up with some number that they are not paying in taxes that they ought to be paying?

Mr. GOLDBERG. We could go down that road of trying to generate those numbers. The data is so gross that I would not rely on it, but you could do it.

Mr. MCGRATH. The $50 billion number thrown around last week at a press conference here was generated from IRS numbers. If it is not you, it is somebody else. It makes our job a heck of a lot more difficult when those numbers of that magnitude are being thrown around.

Mr. GOLDBERG. As I have said, I think that number is way off the mark.

Chairman PICKLE. Mr. Commissioner, I would like for you to submit for our committee the rate of compliance on these cases for U.S. corporations and foreign-owned corporations. I would also like to know the general rate of compliance of taxpayers generally in the United States.

As I recall it, we had hearings that stated with some alarm that the rate of noncompliance might be as much as 20 to 25 percent, the rate of noncompliance. If that is true for individuals, that is scary because our tax system has to depend on voluntary compliance.

There should be a higher percentage for corporations because under the law they would almost be afraid not to file. But I am concerned about the effective rate that they pay. Some of these foreign corporations show they pay as little as 0.5 percent or maybe 1 percent. Your chart showed this morning American companies were paying 3 to 5 percent.

Whatever the rates, they are mighty low. We might have a tax rate of 36 percent but if there is a minuscule effective rate we are not getting much money.

The question really is what is a fair rate. I would like you to give us some percentages for the committee's consideration.

Mr. GOLDBERG. We will try to get together on that.

[The information follows:]

RATE OF COMPLIANCE FOR U.S. AND FOREIGN-OWNED CORPORATIONS AND THE GENERAL RATE OF COMPLIANCE OF U.S. TAXPAYERS

The Internal Revenue Service conducts periodic studies designed to estimate the Income Tax Gap.

The gross tax gap is defined as the amount of income tax liability that is not voluntarily paid. Our estimates of the tax year 1987 gross legal sector income tax gap for corporations range from $13.4 billion to $22.8 billion. Of this, an estimated $8.3 billion will eventually be collected as a result of IRS enforcement. Estimates of the net corporate income tax gap range from $5.2 billion to $14.5 billion. The net income tax gap estimates represent the amount of income tax liability that will remain unpaid after all IRS enforcement activity has been completed for the tax year in question. Based upon past studies, the Corporate Compliance Rate for tax year 1987 is between 81.2 and 88.1 percent.

The studies conducted by IRS do not segregate foreign owned corporations from those that are domestically owned.

Mr. FLIPPO. I think what the chairman and I have been trying to get to all day is some kind of measurement of what is the effective tax rates on corporations, United States and foreign. I think you might have already provided us with some of that data.

In looking at certain ratios that substitute for effective tax rates and looking at the big activity categories you have already furnished, I think it shows ratio 1 is tax after credits divided by receipts. Ratio 1, U.S-owned corporations pay 1.04 and foreign-owned corporations pay 0.066.

Do you see what I am talking about on that list?

Mr. Chairman, I think we could go ahead and look at other ratios of adjusted taxable income divided by receipts. The ratio for U.S.-owned corporations is 4.33 and that of foreign corporations is 2.72. So those differences clearly show that by business activity as reported under section 1120, that these are the ratios that you think are most useful in comparing U.S.-owned with foreign corporations.

Is that essentially correct?

Mr. GOLDBERG. That is correct. The principal point is whatever ratio you look at, you get to the same answer and wide disparity.

Mr. FLIPPO. If you look at 5060, the electronics area and the effective tax rate, well, ratio 1 on that business activity for U.S.-owned companies is 0.90 and for foreign owned it is 0.54.

Mr. GOLDBERG. That is correct.

Chairman PICKLE. Thank you.

Now, Mr. Commissioner, have you or Mr. Lainoff, either one, ever been contacted by any foreign officials or attorneys representing them requesting, for reasons of international trade that the IRS reconsider its position in any pending 482 case?

Mr. GOLDBERG. No, sir, I have not.

Mr. LAINOFF. No, sir.

Chairman **Pickle**. Have you been contacted by anyone in the State Department suggesting you might go easier on some of these companies or careful?

Mr. **Goldberg**. No, sir, I have not.

Mr. **Lainoff**. No, sir.

Chairman **Pickle**. We have been advised that in an automobile case that contact was made by the State Department. If this is so, you are not advised of it?

Mr. **Goldberg**. I have been Commissioner for a year, I believe those cases were before that.

Mr. **Romoff**. It probably happened 9 or 10 years ago, maybe it was 7, 8 or 9 or 10 years ago.

Chairman **Pickle**. It has happened?

Mr. **Romoff**. It did happen, yes.

Mr. **Bergherm**. I believe your question is close to something I have had some experience with. It involved the same case but in two instances.

In one instance, the attorney engaged by the taxpayer approached me in my position in the national office and asked that I consider to impose the national office organization into a process which at that time was under examination in a district office.

Similarly, I was contacted by a foreign tax official and asked for the same action that the national office intercede on that same particular case. In both instances, I declined.

Chairman **Pickle**. Well, I am hoping that is a rare type of expression. It has happened. I think we have got to be on the alert against that type of involvement.

Commissioner, in meeting with your people today, and I think according to the statement you made earlier, you said that you were either outclassed or outgunned as far as personnel is concerned vis-a-vis industry. Your people tell me that they "are outgunned." Is that essentially correct?

Mr. **Goldberg**. That is correct.

Chairman **Pickle**. You have one economist to their 40 economists. You have one tax man to 40 of theirs or some similar comparison. It makes a hard fight, doesn't it?

Mr. **Goldberg**. Yes.

Chairman **Pickle**. I presume that is why so many cases are no change or there is no resolution, or you just finally write it off. The people in the field tell us, and made a lot of references to it, that 482 issues were put on the back shelf because other priorities, workload demand, the cost and time involved in developing these cases. That is happening?

Mr. **Goldberg**. You know, Mr. Chairman, you are running an examination of a taxpayer. It is neither in our interest or the taxpayer's interest. These suckers are taking too long as is.

You have got to make a real-world determination as to when you hold them and when you fold them. I think hopefully that judgment is being done responsibly and carefully on a case-by-case basis. I am not aware of any artificial pressure.

Chairman **Pickle**. What about the reference to a case that we have seen, that has been presented. The prior example cycle dealt with only one product because of pressure to dispose of the case early.

The examination of that one product line alone led to a transfer price adjustment of more than $15 million. Are you familiar with the case?

Mr. **Goldberg**. I have heard that statement made, yes. I am not familiar with the case.

Chairman **Pickle**. What about cases where we start an investigation and we go to a company and they will say "put the examiner in the guard house. Let him operate from there." Or another company would say "put them out there but break the air conditioner." Another company finally gives the IRS agents the records but they bring in 30 boxes of forms and then just dump it in the room and walk off, no index, no nothing. Do those cases happen?

Mr. **Romoff**. Yes.

Chairman **Pickle**. Mr. Romoff says yes.

Mr. Commissioner, you and Mr. Lainoff are having another one of your tete-a-tetes here. Mr. Romoff says that has happened.

Would you care to express yourself on that, Mr. Romoff?

Mr. **Romoff**. In some instances some taxpayers attempt to treat the IRS in a less than professional manner, putting him in the guard house, dumping a lot of records on him. That has happened. That is not just limited to 482 cases, I might add.

Mr. **Goldberg**. I know it has happened. I believe it has happened. I find it reprehensible. But I have got to tell you, there are probably cases where our revenue agents from time to time have imposed unreachable and overburdensome document requests. That is bad, too.

I think we need to be realistic that when those things happen, it is horribly offensive. I do not believe it is standard operating practices and everyone out there is doing it. It is bad, it shouldn't happen, but I don't think it is standard practice.

Chairman **Pickle**. I would hope it is a very rare occasion. In general, are the companies we audit or examine, do they give us cooperation?

Mr. **Goldberg**. I think at that level of accommodations, my guess is you——

Chairman **Pickle**. All right.

Mr. **Goldberg**. I don't think we are getting the cooperation we need in providing us the information to look at the cases. The answer at that level is we are not getting what we need.

Chairman **Pickle**. Do you want to make a comment, Ms. Lewin?

Ms. **Lewin**. The majority of the cases we have been able to set up a professional relationship with the taxpayers' personnel. It goes fairly smoothly. I would obviously like to get everything I ask for, like yesterday. But the great majority of the taxpayers it goes smoothly.

I have had a couple of cases where there was definite mistreatment of everybody doing the auditing.

Chairman **Pickle**. Well, I have many questions, Mr. Commissioner, that I want to ask you. This would take another hour. We look forward to having you back with us again. We enjoyed having you here before our committee.

I do want to hear Mr. Lane. I am not going to ask any more questions at this particular point.

I think I would say in conclusion that it is encouraging to know that you have added consistently to your international force. We are getting more funds than we used to.

We have a lot of cases in the pipeline. But I have the feeling as a member of this committee that we have not concentrated on this issue and that we have simply allowed it to exist and accepted the fact that it is very complicated, it is an international matter, it is easier not to get too deeply involved because of international trade and the relationship that goes with it. Therefore, we simply haven't concentrated on it.

If indeed we are losing $13 to $20 billion because we are not enforcing 482, then we either need to do something in addition to 482 or at least enforce it. Perhaps it will require a long-term commitment by both the Congress, the IRS, and Treasury.

Until the administration says they want to do it, we are going to be dragging our feet. Gradually when these things are made known to the American public, there is going to be an uprising of people who say this is not right. I think we all have to do better.

We are going to be listening to the administration on Thursday. It may be, Commissioner, we will have you back up here with us again. We are going to look at other aspects of this issue.

In the meantime we will be submitting to you a lot of questions. We will ask you in the interest of coordinating with our committee that you try to give us quick responses so we will know how to conduct the other hearing. We ask you to cooperate. I know you will because you always have given us excellent cooperation.

[The following was subsequently received:]

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August 15, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

I want to thank you for your testimony at the Oversight Subcommittee's hearing on the level of tax payments by foreign-owned U.S. subsidiaries. To complete our hearing record, I would appreciate receiving your responses to the following questions by Friday, August 31, 1990. These questions are in addition to the information requested at the hearing.

1. The IRS estimates that between one fourth and one third of the nearly $100 billion annual gross income tax gap is attributable to shortfalls in the corporate tax. Has the IRS made any estimates of how much of this annual tax gap is attributable to taxes owed by foreign-controlled subsidiaries operating in the U.S.? How much of the tax gap is due to improper "outbound" transfer pricing by U.S.-controlled corporations? Please provide figures and explain how those figures were calculated.

2. IRS has published statistics of income data for many years broken down by foreign-controlled and U.S.-controlled corporations. Some say the data might be interpreted to indicate that foreign-owned subsidiaries are not paying their "fair share" of taxes or that the taxes paid by foreign-owned subsidiaries "are too low", either in comparison to U.S.-owned companies or relative to their gross receipts, assets, taxable income, or other ratio. To what extent does IRS data suggest that foreign-controlled U.S. corporations do not pay sufficient levels of U.S. tax? What specific factors explain the apparently lower levels of tax paid by foreign-controlled corporations compared to U.S.-controlled corporations? How is it that the receipts and assets for foreign-controlled subsidiaries have increased in recent years, yet taxes paid have decreased?

3. What ratios or statistics do you find most useful to make comparisons between taxes paid by U.S.-controlled and foreign-controlled firms? What do those ratios show?

4. What is the difference in terms of compliance in outbound section 482 cases and inbound cases? To what extent are the issues the same or different? Besides automobile, motorcycle, and electronics equipment distributors, what other businesses are engaged in improper transfer pricing?

5. No one has been able to pin down the extent to which foreign-owned subsidiaries are avoiding paying taxes anywhere in the world. We have heard that income being shifted from the U.S. is going into tax haven countries like Singapore. Please provide any information on the use of tax havens by multinationals, both domestic and foreign.

6. You testified that the IRS Manhattan office currently has five economist and fifteen international examiner vacancies. On July 10, 1990, exactly how many economists did the IRS have as permanent employees? How many international examiners? How many section 482 cases were there in the IRS's inventory? Approximately how many new cases are opened each year? How many are closed? How much is collected?

7. Questions were raised during the hearing concerning whether the IRS has ever imposed penalties as a result of section 482 adjustments. Have any of the subsidiaries that have been found by examination to have significantly and consistently underpaid their U.S. taxes been penalized? Have the companies ever paid penalties? If no, why not?

8. In response to questions submitted to the IRS following Oversight's hearing on the IRS accounts receivable inventory, the IRS indicated that it currently has some fraud cases involving foreign-owned corporations being worked by the agency's Criminal Investigation function. Please provide detailed information on these cases in publicly disclosable form, and in non-disclosable form under separate cover, (including the names of the companies under investigation, the issues the Criminal Investigations Division is pursuing and the extent to which any of the investigations relate to transfer pricing.)

9. The Internal Revenue Code section 1059A provides that importers subject to U.S. tax may not claim a transfer price for tax purposes which is higher than they claim for Customs purposes. This applies to transactions between related parties after March 18, 1986. Is this provision being complied with? How many violations have you found? What penalties apply and how many have been asserted? To what extent does the IRS know whether the subsidiaries are providing different numbers to IRS and Customs? How would the IRS know?

10. Mr. Don Bergherm testified that during the past several years, the IRS has conducted approximately 100 simultaneous examinations with treaty countries. Please describe the simultaneous audit procedures, when they are employed, and the 100 cases in which the procedures were used. Provide under separate cover, in detailed publicly disclosable form, and in non-disclosable form, the results of those audits, and the amount of money collected.

11. Representatives of foreign-controlled companies have suggested that heavy costs associated with starting up new U.S. plants, particularly auto factories, explain the decline in taxable income by such firms. To what extent have "start-up costs" in fact contributed to the decline in corporate tax payments by foreign-owned automobile, motorcycle, and electronics equipment companies? In other industries?

12. Does the IRS have any evidence that foreign-owned companies are engaging in improper transfer pricing practices with regard to components and parts?

13. If foreign-owned distributors underpay Federal income taxes, to what extent do they have more money available for research and development, sales and service infrastructures, and promotional incentives? To what extent does the underpayment of Federal income tax affect competitiveness?

14. To what extent has the IRS conducted examinations of medium or small distributors of durable goods, such as automobile parts distributors? Is it cost effective to conduct such complicated audits on smaller companies? How is the IRS enforcing the tax laws with regard to these companies? What ideas does the IRS have on the drawing board to deal with these companies?

15. Has the government only discovered and examined the "tip of the iceberg" as it relates to section 482 issues? To what extent can the 44,000 foreign-owned companies that file Federal income tax returns in the U.S. engage in improper transfer pricing without being detected? With the millions of transactions that occur each month across national borders, will the IRS ever be able to effectively enforce our Federal tax laws?

16. According to IRS attorneys interviewed by the Subcommittee staff, the U.S. Tax Court has repeatedly hampered the IRS with regard to discovery. According to the attorneys, multinationals withhold information thus preventing the IRS from developing transfer pricing cases during the examination process. The same companies often refuse to extend the statute of limitations forcing the IRS to issue statutory notices of deficiency based on limited data. Once the corporation files a Tax Court petition, the IRS attorneys claim they are effectively placed at a severe disadvantage because the court unreasonably limits discovery. How does the Tax Court limit discovery? How does Tax Court discovery compare with the District Courts and the Claims Court? What can be done to remedy this problem?

As always, I appreciate your attention to this request. I look forward to working with you in seeking ways to improve compliance with our Federal tax laws. If you have any questions, please contact Rusty Guritz or Patrick Heck at 225-5522.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/phw

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

OCT 10 1990

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Ways and Means
Subcommittee on Oversight

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
House Committee on Ways and Means
1105 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

This is in response to your letter of August 15, 1990 asking a number of questions to follow up on the Subcommittee's hearing on the level of tax payments by foreign-owned U.S. subsidiaries.

If your staff has any questions, please have them contact Rick Hinkemeyer, Acting Director of Legislative Affairs Division at 566-6070.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Enclosure

1. **The IRS estimates that between one fourth and one third of the nearly $100 billion annual gross income tax gap is attributable to shortfalls in the corporate tax. Has the IRS made any estimates of how much of this annual tax gap is attributable to taxes owed by foreign-controlled subsidiaries operating in the U.S.? How much of the tax gap is due to improper "outbound" transfer pricing by U.S.-controlled corporations? Please provide figures and explain how those figures were calculated.**

   In conducting its tax gap studies the IRS has not made any estimates of how much of the annual tax gap is attributable to taxes owed by foreign controlled subsidiaries operating in the U.S. Also, because no estimates based on specific issues were made in these studies, we do not know how much of the tax gap is due to improper "outbound" transfer pricing by U.S. controlled corporations.

2. **IRS has published statistics of income data for many years broken down by foreign-controlled and U.S.-controlled corporations. Some say the data might be interpreted to indicate that foreign-owned subsidiaries are not paying their "fair share" of taxes or that the taxes paid by foreign-owned subsidiaries "are too low", either in comparison to U.S.-owned companies or relative to their gross receipts, assets, taxable income, or other ratio. To what extent does IRS data suggest that foreign-controlled U.S. corporations do not pay sufficient levels of U.S. tax? What specific factors explain the apparently lower levels of tax paid by foreign-controlled corporations compared to U.S.-controlled corporations? How is it that the receipts and assets for foreign-controlled subsidiaries have increased in recent years, yet taxes paid have decreased?**

   The published statistics of income ("SOI") data reflects information reported on tax returns as filed with the IRS, and does not reflect the result of any audit adjustments. The published data subdivides corporate tax return filers by broad categories of business activity, and the numbers represent the aggregate return information of all corporations engaged in those broad categories of business activity. Thus, for example, the published SOI data aggregates the gross receipts and the expenses of the most profitable corporations with the gross receipts and expenses of the least profitable corporations operating at a loss.

   As you correctly stated on the floor of the House after the first day of hearings on this subject, there are profitable foreign controlled U.S. corporations that do pay significant amounts of U.S. income tax. It is also important to recognize at the outset that aggregate data cannot, and does not prove noncompliance by all foreign controlled U.S. corporations.

   Nevertheless, a comparison of the data on foreign controlled U.S. corporations with the data on all other U.S. corporations filing U.S. income tax returns does support IRS' concern about the level of tax paid by foreign controlled U.S. corporations in general. These comparisons strongly suggest that foreign controlled corporations as a class may be substantially understating their U.S. income tax liability, and we believe that the data surely justifies close scrutiny of foreign controlled corporations.

   Among the explanations offered to explain the troubling differences between the aggregate data on foreign controlled U.S. corporations and U.S. controlled corporations is the higher level of operating expenses (including depreciation) that might be expected to be associated with the increasing presence of foreign controlled U.S. corporations, including start-up operations in the United States, and the concomitant increase in U.S. receipts and assets over the past several years. In addition, the capital structure of foreign controlled corporations may be more weighted toward debt than equity, thus increasing the deductible operating expenses of those corporations over U.S. controlled corporations. As discussed in the answer to question 11, below, an analysis of the aggregate SOI data by the Office of Tax Analysis of the Department of Treasury, has indicated that foreign controlled corporations as a whole do not appear to have significantly higher levels of depreciation or payments on debt, as compared to their assets, than do U.S. controlled corporations. However, the potential importance of start-up costs as an explanation can only be resolved by examining the performance of individual companies over time. Finally, the effects of foreign currency fluctuations, and the decrease in the value of the U.S. dollar in relation to foreign currencies has been offered as an additional explanation although this explanation does not account for the persistence of the trends noted.

3. **What ratios or statistics do you find most useful to make comparisons between taxes paid by U.S.-controlled and foreign-controlled firms. What do those ratios show?**

Among the statistical comparisons that contribute to our concern about noncompliance by foreign controlled U.S. corporations, is that of the percentage of profitable foreign controlled corporations with the percentage of profitable U.S. controlled corporations. The percentage of profitable foreign controlled U.S. corporations is significantly lower than the percentage of profitable U.S. controlled U.S. corporations over a substantial period of years. A comparison of the net income (less deficit) as a percentage of gross receipts or assets of foreign controlled corporations, in the aggregate, with U.S. controlled corporations in the aggregate also reflects the trend of lower profitability of foreign controlled corporations over a period of time. This trend of unprofitability has been confirmed by our audit experience with some foreign controlled corporations.

In short, the aggregate data over a period of years indicates that the percentage of unprofitable foreign controlled corporations is higher than the percentage of unprofitable U.S. controlled corporations, and the net income of those foreign controlled corporations is smaller in relation to gross receipts than that of U.S. controlled corporations. While aggregate tax return data by itself is not conclusive proof of tax evasion by specific corporations, it does certainly suggest that scrutiny of foreign controlled corporations as a whole is warranted.

4. **What is the difference in terms of compliance in outbound section 482 cases and inbound cases? To what extent are the issues the same or different? Besides automobile, motorcycle, and electronics equipment distributors, what other businesses are engaged in improper transfer pricing?**

Compliance problems exist for both inbound and outbound transfer cases. We are unable, however, to state quantitative compliance rates because we have not performed a statistical study of these transfer issues.

Outbound section 482 adjustments are generally related to the transfer of technology, services, intangibles, and tangible property to or through a tax haven country to be used to produce tangible goods for sale back to the U.S. or to other industrial countries. Inbound section 482 adjustments are more frequently related to (1) the transfer of manufactured tangible assets into the U.S. by a foreign subsidiary of the U.S. company, and (2) the transfer of tangible assets by a foreign company to a related entity operating in the U.S. The inbound and outbound section 482 adjustments are similar in that the adjustment results from the changing of the transfer price to an arms-length market price.

Foreign companies normally transfer tangible assets to related entities doing business in the U.S. Businesses other than autos, motorcycles and electronics which have raised transfer pricing issues include chemicals, petroleum, metals, food products, clothing and manufactured goods in labor intensive industries.

5. **No one has been able to pin down the extent to which foreign-owned subsidiaries are avoiding paying taxes anywhere in the world. We have heard that income being shifted from the U.S. is going into tax haven countries like Singapore. Please provide any information on the use of tax havens by multinationals, both domestic and foreign.**

The use of so-called tax havens by U.S. and foreign multinational corporations may be either abusive or legitimate. "Tax haven" is the term generally applied to any jurisdiction that imposes a low general rate of tax and that may also have financial secrecy laws. The term may also be applied to a jurisdiction that imposes a significantly high general rate of tax, but which mitigates that high tax rate by offering generous tax incentives that result in a low effective tax liability for taxpayers that engage in types of activity that the jurisdiction intends to encourage.

Concern about the use of tax havens for purposes of tax evasion arises when income otherwise subject to tax by a high tax jurisdiction is routed to a tax haven country. The concern is that income that might otherwise be subject to tax by a high tax jurisdiction is being "parked" in a tax haven for the purpose of avoiding a high level of tax. For example, passive investments may be shifted from high tax jurisdictions to a tax haven solely to avoid tax.

One method of improperly using tax havens is the diversion by a manufacturer of unreasonably high levels of profits to a tax haven jurisdiction. Income might be shifted by a manufacturer to a tax haven by attributing it to minimal processing activities there, or by inflating the manufacturer's deductible expenses by paying high fees for services nominally provided in the tax haven. Again the goal would be to defer or avoid high levels of tax in either the jurisdiction where the real value of a product or service originated or the jurisdiction where a final product is destined for ultimate use.

The use of tax havens by domestic (U.S.) multinationals, is a potential target of section 482. When a U.S. multinational shifts profits to a commonly controlled tax haven corporation through transfer pricing or inflated expenses, and attributes them to minimal production or other activities performed there, section 482 allows the IRS to reallocate income among the commonly controlled corporations, to the extent it is necessary to do so to prevent evasion of taxes, or to clearly reflect income. Thus, section 482 would allow the IRS to allocate to the tax haven only the amount of income properly attributable to the activities performed there.

Alternatively, the use of tax havens might also be deterred by the application of the anti-deferral rules of Subpart F (sections 951, *et seq.*, of the Code). A taxpayer's benefit from the deferral of U.S. taxes that can result by improperly shifting income to a tax haven might be completely eliminated by operation of the provisions of Subpart F. For example, one aspect of Subpart F disregards any activity in a tax haven that does not rise to the level of "manufacturing," and requires current U.S. taxation of all manufacturing income improperly shifted to that tax haven.

In the case of foreign multinationals, with U.S. subsidiaries, the IRS might also use section 482 to reallocate income among commonly controlled corporations. Similarly, a tax authority of a foreign high tax jurisdiction country might use its equivalent of section 482 to do the same in order to ensure that its tax is not being improperly avoided.

Tax avoidance could also occur in the case of some foreign multinationals that operate through U.S. branches rather than subsidiaries, when income and expenses must be allocated between taxable U.S. operations and nontaxable foreign operations of the foreign corporation. For example, a foreign multinational that is in the financial services business in the United States and abroad might keep income producing assets in a tax haven in an attempt to avoid the income tax imposed by its high tax home country and the

United States. Those assets might be an integral part of the U.S. and home country business operations, and the U.S. business and the foreign business operations of the foreign multinational might both benefit substantially from the assets in the tax haven. However, by physically locating those assets in the tax haven, the foreign multinational might argue that the income attributable to those assets falls through the cracks of both the United States' and its home country taxing jurisdictions, and must be traced solely to, and be taxable only by, the tax haven country.

6. **You testified that the IRS Manhattan office currently has five economist and fifteen international examiner vacancies. On July 10, 1990, exactly how many economists did the IRS have as permanent employees? How many international examiners? How many section 482 cases were there in the IRS' inventory? Approximately how many new cases are opened each year? How many are closed? How much is collected?**

At the time of the hearing, IRS employed 35 permanent economists and 480 international examiners. According to a field survey taken in June in anticipation of the hearing, international examiners were exploring the implications of section 482 in about 1000 instances. However, some cases contain multiple transactions to which section 482 could potentially apply. Therefore, the number of cases will be substantially less. In fact, according to our records for 1989, only 114 closures by international examiners contained section 482 adjustments. Through May of 1990, 137 closures by international examiners contained section 482 adjustments. We do not maintain information on the amount of collections which are made on single issue adjustments.

7. **Questions were raised during the hearing concerning whether the IRS has ever imposed penalties as a result of section 482 adjustments. Have any of the subsidiaries that have been found by examination to have significantly and consistently underpaid their U.S. taxes been penalized? Have the companies ever paid penalties? If no, why not?**

As explained by our field personnel during the hearing, penalties are proposed when justified on all cases under examination, including cases involving section 482 issues. Current examples of such penalties imposed on foreign controlled corporations are evident in pending litigation with Yamaha Motor Corporation, Tax Court Docket No. 2674-88, involving proposed assessments of $132.9 million tax plus substantial understatement penalties, and with Daewoo International (America) Corporation, Tax Court Docket No. 10,025-89, involving proposed assessments of $29.9 million tax plus penalties.

Although penalties are not assessed by international examiners due to their positions as consulting specialists, they nonetheless routinely recommend penalties where appropriate. For example, our International Enforcement Division, which collects summary data regarding international examinations, has within the last month received three reports of completed international examinations in which penalties were proposed on section 482 adjustments made with respect to foreign controlled corporations. We do not, however, have at this time a means of identifying which foreign controlled companies have in fact paid or not paid penalties principally resulting from section 482 adjustments.

8. **In response to questions submitted to the IRS following Oversight's hearing on the IRS accounts receivable inventory, the IRS indicated that it currently has some fraud cases involving foreign-owned corporations being worked by the agency's Criminal Investigation function. Please provide detailed information on these cases in publicly disclosable form, and in non-disclosable form under separate cover, (including the names of the companies under investigation, the issues the Criminal Investigations Division is pursuing and the extent to which any of the investigations relate to transfer pricing.**

As previously noted, the IRS indicated that it currently has three fraud cases involving foreign owned corporations being investigated by the agency's Criminal Investigation Division. The following is an edited version of these cases in publicly disclosable form. All three cases are currently in open investigation status, therefore, no civil action will occur until the criminal issues are resolved.

Case Number 1 involves an individual in the U.S. who used his position as an employee of a subsidiary of a major foreign corporation to allegedly enter into unauthorized monetary transactions involving the buying and selling of foreign currency for personal profit in conspiracy with four foreign citizens who were also employees of the foreign corporation.

Profits from the unauthorized transactions were allegedly funneled into accounts located in another foreign country under the control of the U.S. employee.

This matter is currently being pursued by the United States Attorney through the grand jury process.

Case Number 2 involves a money laundering scheme, whereby a foreign bank doing business in the U.S. solicited depositors by advertising in a foreign language that their cash deposits would be kept secret and the funds would be returned to them from the foreign country in three days without the knowledge of the Internal Revenue Service. It is alleged that over $700 million was laundered in this scheme to evade taxes.

To date, thirteen individuals are charged with conspiracy to violate U.S. Currency reporting laws. In addition, three of the executives were charged with conspiracy to launder $250,000 a week from illegal gambling receipts.

The current status of this case is that the defendants have been indicted for Title 31 violations and a trial has been scheduled to commence in the near future.

Case Number 3 involves a kick back scheme by an employee of a domestic subsidiary of a foreign corporation. The employee caused officers of a foreign bank operating in the United States to issue unauthorized letters of credit for the benefit of the foreign parent corporation. The foreign parent corporation then issued these letters of credit to a foreign country as part of the United States Commodities Credit Corporation's export credit guarantee program. If this scheme were successful and the foreign country did not make payment for their purchases, the United States would have to guarantee the payments since the letters of credit would be unenforceable.

This matter is currently being pursued by the United States Attorney through the grand jury process.

9. **The Internal Revenue Code section 1059A provides that importers subject to U.S. tax may not claim a transfer price for tax purposes which is higher than they claim for Customs purposes. This applies to transactions between related parties after March 18, 1986. Is this provision being complied with? How many violations have you found? What penalties apply and how many have been asserted? To what extent does the IRS know whether the subsidiaries are providing different numbers to IRS and Customs? How would the IRS know?**

Section 1059A is still a relatively new provision, and the Service has not yet had the opportunity to develop an extensive compliance record for it. A survey taken of the field in anticipation of the hearings indicates that section 1059A has been applied to only three cases to date. As the Committee is aware, section 1059A must be applied on a transaction-by-transaction basis. As a consequence, in the situations posed by the foreign-owned electronics companies that were reviewed by your staff, for example, the use of section 1059A would require our International Examiners to examine thousands of transactions in the course of an audit.

Due to the extreme inefficiency of utilizing section 1059A on inbound transactions, IRS is generally pursuing the use of the resale price methodology in making section 482 adjustments on foreign-owned corporations. This allows us to take a more aggregate approach to these examinations, a much more efficient use of our resources. As a result, we have not attempted to capture any significant amount of statistical data regarding this Code section.

10. **Mr. Don Bergherm testified that during the past several years, the IRS has conducted approximately 100 simultaneous examinations with treaty countries. Please describe the simultaneous audit procedures, when they are employed, and the 100 cases in which the procedures were used. Provide under separate cover, in detailed publicly disclosable form, and in non-disclosable form, the results of those audits, and the amount of money collected.**

Since the inception of the Simultaneous Examination Program in 1977, the IRS has conducted 48 simultaneous examinations with various treaty partners, including five examinations currently in process. These examinations usually cover two tax years, in some cases three tax years, so the total number of tax years which have been examined would be at least 100.

In the simultaneous examination process, taxpayers are independently identified for simultaneous examination by tax administration officials of each country using specific case selection criteria. Each country will then inform the other of its choice of potential cases. Each country will determine whether it wishes to participate in a particular simultaneous examination. Neither country, however, is obligated to cooperate in all examinations proposed by the other country. If both countries agree to conduct a simultaneous examination, each country will then separately examine the taxpayer under its jurisdiction. The examination teams of both countries meet to plan and coordinate their examinations, and during the examination information is exchanged in accordance with the provisions of the Income Tax Convention between them.

The following factors are considered in determining when to employ simultaneous examination procedures:

1) Scale of worldwide operations;

2) Extent of intragroup transactions;

3) Compatible tax years;

4) Indication of substantial noncompliance of tax laws in both countries; and

5) Activities involving tax havens.

In the 48 cases which were selected for simultaneous examination, all of these factors were present.

Records of the results of the closed simultaneous examination cases were not maintained prior to FY 1988. The examinations for cases subsequent to FY 1987 are still in process, and thus results are not yet known.

11. **Representatives of foreign-controlled companies have suggested that heavy costs associated with starting up new U.S. plants, particularly auto factories, explain the decline in taxable income by such firms. To what extent have "start-up costs" in fact contributed to the decline in corporate tax payments by foreign-owned automobile, motorcycle, and electronics equipment companies? In other industries?**

In answering this question, it is important to distinguish between the inferences to be drawn from aggregate SOI data, and the results of actual audit experience. Clearly, in certain years of certain specific taxpayers, start-up costs associated with the construction of new U.S. plants may account for a decline in U.S. corporate tax payments. However, start-up costs are not necessarily the only explanation for low levels of tax paid in the aggregate by foreign controlled U.S. corporations over all the years reviewed during the hearings. For example, during some of the years, some foreign controlled corporations may have been merely distributors, and not have had U.S. production facilities.

Moreover, an analysis of the aggregate SOI data by the Office of Tax Analysis of the Department of the Treasury has shown the general notion that, when compared to U.S. controlled corporations, foreign controlled U.S. corporations did not, in the aggregate, incur the higher levels of depreciation, or higher levels of debt in relation to total assets, that might be expected to be associated with start-up operations. Thus, these specific start-up costs do not completely account for the relatively lower level of U.S. net taxable income and U.S. income tax paid as reflected over the period covered by the aggregate SOI data. Some representatives of foreign controlled corporations have offered the effect of foreign currency fluctuations as an additional partial explanation for lower levels of U.S. tax paid by foreign controlled corporations. However, there has been little evidence offered to date to prove that any adverse impact of currency fluctuations was felt more by foreign controlled corporations than U.S. controlled corporations, or that foreign controlled corporations were less able than U.S. controlled corporations to hedge against any adverse effects of currency fluctuations. Moreover, this explanation does not account for the long-term trends observed.

With respect to specific foreign controlled taxpayers in the specific industries about which you asked, the proposed audit adjustments, if any, for particular years would provide the IRS' response to an assertion of start-up costs as a defense. In the course of an audit, the IRS would examine the specific facts of a foreign controlled taxpayer, and determine the extent to which a taxpayer may have evolved from a distributor into a manufacturer, or been replaced by a manufacturer, and the extent to which legitimate start-up costs associated with a new production facility may have been incurred.

12. **Does the IRS have any evidence that foreign-owned companies are engaging in improper transfer pricing practices with regard to components and parts?**

In the examinations of the major foreign auto parts and accessories importers, we are unaware of any specific transfer pricing adjustments under section 482. There are some potential section 482 issues in process involving vehicles and component parts; such as, the transfer of "knock down kits" to be assembled as vehicles in the U.S. at transfer prices below the market value. There are some section 482 adjustments in process in the transfer of electronics parts and components.

13. **If foreign-owned distributors underpay Federal income taxes, to what extent do they have more money available for research and development, sales and service infrastructures, and promotional incentives? To what extent does the underpayment of Federal income tax affect competitiveness?**

The question assumes that the underpayment of taxes would result in excess funds being available for alternate uses, including research and development (R&D), etc. If we assume that a foreign controlled corporation is understating its net profit due to overstated transfer prices, the "excess profit" which is disguised as the overinflated portion of the transfer price is simply absorbed by that specific transfer price and transferred offshore for use in the operations of the foreign owners.

With regard to the extent of competitiveness of the underpayor of Federal income taxes, the connection between the two is clearly speculative. Excess funds created through the use of overstated transfer prices are available for alternate uses. Recognizing that the funds, through the overstated transfer prices, are shifted offshore, the foreign parent corporation may use these funds to increase its competitive edge, may simply shift its tax payments (assuming tax rates comparable to the U.S.) to its own government's treasury or may squander these funds on risky or shaky investments or ventures. We have no means at our disposal to trace the end use of such funds except to say that the foreign parent obviously has the potential for increasing its competitive edge through the use of transfer pricing that artificially reduces the Federal income of its controlled domestic U.S. corporation.

14. **To what extent has the IRS conducted examinations of medium or small distributors of durable goods, such as automobile parts distributors? Is it cost effective to conduct such complicated audits on smaller companies? How is the IRS enforcing the tax laws with regard to these companies? What ideas does the IRS have on the drawing board to deal with these companies?**

Small and medium sized distributors of durable goods are examined when selected based on the normal classification examination criteria. The cases would normally be selected because of some exceptional item on the return or as the result of international classification activities. The cost effectiveness of these examinations would be a factor in determining the number examined. Under the current selection systems only those with adjustment potential would receive an in-depth examination.

A project currently being developed by the International Enforcement Division will identify and associate by computer analysis related distributors controlled by foreign entities. Initial work on this project indicates that major foreign companies operate on a fragmented entity basis in the U.S. to avoid being identified in the large case examination program. This project is expected to be implemented during fiscal year 1991. Another program is in process to identify and examine smaller foreign owned companies for the purpose of evaluating compliance and developing efficient examination techniques. This program is looking at companies smaller than the large case CEP cases, but with assets above $10 million.

15. **Has the government only discovered and examined the "tip of the iceberg" as it relates to section 482 issues? To what extent can the 44,000 foreign-owned companies that file Federal income tax returns in the U.S. engage in improper transfer pricing without being detected? With the millions of transactions that occur each month across national borders, will the IRS ever be able to effectively enforce our Federal tax laws?**

As noted at the hearing, the principal issue arising in the examination of foreign controlled corporations (FCCs) is transfer pricing, ranging from the costing of inventory to the interest rate charged on parent-subsidiary loans. Approximately 500-600 FCC's are under audit during any given year. For tax year 1987 returns, we currently plan to audit approximately 600 FCC's. While this represents only 1.3% of FCC returns it covers those FCCs reporting more than 50% of the total assets and gross receipts for that year. Therefore, we believe that we are able to identify the majority of the dollars at stake in section 482 issues arising in the foreign controlled arena.

IRS efforts in the transfer pricing area are of relatively recent vintage, as they relate to FCC's. Accordingly, in light of the time it takes to develop specific cases, it is not yet possible to assess the impact of these efforts. However, as we gain experience and increase our international resources, we expect to improve our quality and productivity in this area.

16. **According to IRS attorneys interviewed by the Subcommittee staff, the U.S. Tax Court has repeatedly hampered the IRS with regard to discovery. According to the attorneys, multinationals withhold information thus preventing the IRS from developing transfer pricing cases during the examination process. The same companies often refuse to extend the statute of limitations forcing the IRS to issue statutory notices of deficiency based on limited data. Once the corporation files a Tax Court petition, the IRS attorneys claim they are effectively placed at a severe disadvantage because the court unreasonably limits discovery. How does the Tax Court limit discovery? How does Tax Court discovery compare with the District Courts and the Claims Court? What can be done to remedy this problem?**

The litigation of a transfer pricing case may present unique problems because proper development of such a case often requires the production of massive amounts of precise information covering several tax years. Given the factual complexity of such cases, and the IRS' limited resources, the three year statute of limitations does not allow time for the resolution of document requests and summonses for all the relevant information necessary for adequate development of the case at the examination stage. Taxpayers wishing to frustrate the development of a case can do so at any time by refusing to sign consents extending the statute of limitations. When a case is not fully developed administratively, the factual development of the examination may be ultimately forced into the Tax Court.

Once before the Tax Court, the Service's discovery may be limited, as a practical matter, because taxpayers are potentially able to exploit the court's historic preference for "informal" (voluntary) discovery and the stipulation process, over "formal" discovery. Although the Tax Court's philosophy of encouraging informal discovery may be ideal for cases involving individual taxpayers, it is not always compatible with the conduct of a lawsuit involving large multinational corporations and issues involving hundreds of millions of dollars. In large case litigation, in general, and section 482 litigation in particular, procedural tactics are used to achieve delays in producing information in an attempt to avoid any disclosure of adverse information.

The Service's problems in the Tax Court generally arise after a case has been assigned to a regular judge for trial. At that point the court may expect the parties to have substantially completed discovery or at least to have adequately identified the issues to be tried. Extensive discovery sought thereafter may be viewed as inconsistent with the Court's goal of expeditiously moving the case along to a proper disposition.

The Tax Court has in some cases limited discovery because of a disagreement with the IRS as to whether an issue was raised prior to the time of trial. In such cases, the court has restricted the extent to which the Service is permitted to inquire into matters that were not raised at the time of the examination. The stated basis for such refusal is the limitation set forth in Tax Court Rule 70(b), that discovery may concern only matters which are relevant to the subject matter involved in the pending case. "Subject matter" in this context is defined by the issues raised in the notice of deficiency and the pleadings.

To the extent issues are deemed to have been properly raised and discovery is appropriate, the Tax Court has historically still expressed a preference for informal discovery. Rule 70 of the Tax Court's Rules of Practice provides that "the Court expects the parties to attempt to attain the objectives of discovery through informal consultation or communication before utilizing the discovery procedures provided in these Rules." Thus, tactics of delay are still possible, which may push formal discovery to a time closer to the commencement of the actual trial date, when it may be too late to execute a second discovery request after receiving a response to a first request. By contrast, the U.S. District Courts and the Claims Court, which may also have crowded dockets, allow formal discovery to begin immediately after the pleadings are closed.

The Tax Court rules also make it very difficult to execute third party discovery. Although Tax Court Rule 75 allows counsel to take depositions of a third party without consent of opposing counsel, Rule 75(b) limits operation of the rule to "extraordinary" situations. The interpretation of the term "extraordinary" is potentially subject to a different interpretation by each of the court's judges. Again, by contrast, under the Federal Rules of Civil Procedure, as applied in the U.S. District and Claims Court, a party may depose "any person, including a party" without leave of court and may compel attendance by subpoena after the 30th day following commencement of the action.

The ultimate remedy for this problem is for audits to be fully completed at the examination stage. However, this does not mean that it should be necessary to develop every section 482 case as if it were going to trial, as this would not be an efficient allocation of IRS resources, and would also unfairly burden taxpayers that were not guilty of procrastination.

The solution to this problem will require a long term commitment to devote more resources to the IRS in a thoughtful and systematic fashion. These resources must include more than financial resources. They should include additional legislative tools, as well. One candidate for legislation to help accomplish these goals would be a provision that would prevent both U.S. and foreign taxpayers from using the statute of limitations to obstruct legitimate requests for information at the examination stage, and to force development of an audit into the trial stage. We have been working with the Subcommittee's staff on such a proposal.

Chairman PICKLE. I don't think I have any other questions at this time, Mr. Commissioner, unless you have an additional statement to make. If you don't and you want to let well enough alone, we will just retire for the evening.

Mr. GOLDBERG. Thank you, Mr. Chairman. I would like to take the opportunity to thank your staff for a professional job well done.

Chairman PICKLE. Thank you. I think they have done an excellent job, and I appreciate you saying so.

Now, Deputy Commissioner Lane, come forward. I will ask you to proceed.

I apologize profusely for this late date. We should have rearranged our schedule to allow you to testify earlier. We did not realize it would take this turn. We owe you one.

STATEMENT OF HON. MICHAEL H. LANE, DEPUTY COMMISSIONER, U.S. CUSTOMS SERVICE, ACCOMPANIED BY RICHARD ROSETTIE, DEPUTY ASSISTANT COMMISSIONER FOR COMMERCIAL OPERATIONS, AND JOHN ESAU, SPECIAL AGENT, COMMERCIAL FRAUD ENFORCEMENT CENTER

Mr. LANE. Thank you.

With me here today on my right is Deputy Assistant Commissioner Richard Rosettie from the Office of Commercial Operations, and Special Agent John Esau, the acting head of our Commercial Fraud Enforcement Center.

Mr. Chairman, I am here today to discuss Custom's regulatory audit program in regard to related party and transfer price transactions.

The Customs Office of Regulatory Audit has approximately 300 personnel assigned to 23 field locations and Washington. Regulatory audit is responsible for auditing international trade programs such as the Canada Free Trade Agreement, the Caribbean Basin Initiative and the general system of preferences, all of which afford benefits to imported commodities. In addition, audits of program areas such as drawback, custom house brokers, foreign trade zones and general importer compliance are performed to ensure the protection of the revenue. Each year regulatory audit performs approximately 600 audits and over the last 5 years has had an average recommended recovery of $56 million.

Throughout its 16-year history of major importer audits, Customs Office of Regulatory Audit has been auditing an equal share of unrelated and related party transactions. The related party transactions have usually involved American companies maintaining a foreign subsidiary structure. While Customs continues to audit companies which operate on an unrelated basis, an expanded dimension to related party audit verifications has come about because of the increase of foreign firms with subsidiaries in the United States.

With the increase of international trade and the development of the multinational corporation, the audit environment has become more complex. At an ever-increasing rate, Customs has had to deal with importers and exporters which are related to one another.

The primary concern in all related party transaction audits is to ensure that the prices and values reported for the imported commodities truly reflect all of the transaction in order to ensure proper collection of moneys owed to the Treasury. When such companies are audited, Customs focuses on verifying that the relationship between the parent and the subsidiary does not affect the pricing structure. In the unrelated party transaction, the importer who is not related to the supplier contracts to have his merchandise exported to the United States in an arms-length deal—seller and buyer agree on a price which includes the direct cost of manufacturing, the allocation of overhead, and a profit margin for the supplier or seller.

When the U.S. subsidiary or the importer is related or wholly owned by the supplier or parent located in a foreign country, that relationship can cloud the objectivity of the value or price of the merchandise. In an arms-length transaction, absent fraud, the market sets the price. When there is a relationship, there is a question as to the basis for the pricing. Undervaluation of merchandise reduces revenues lawfully due the Treasury. This is true for the company whose parent is located in New York, Chicago, Los Angeles or in London, Ambsterdam, or Tokyo.

In any related party transaction, it may be necessary to have access to the records that are maintained by the parent as well as those maintained in other countries by the related subsidiary.

Because Customs has had more exposure to American parent/foreign subsidiary transactions over the years we have learned to deal more effectively in this arena. In this case, we have the basic authority and tools to generally obtain the information necessary to make value determinations. Customs has the ability to summon those records necessary to complete the audit process. However, when dealing with the foreign-owned and located corporation, Customs does not have legal access to records maintained at that foreign parent location. Customs needs access to this information from multinationals regardless of the location of the parent to ensure that merchandise is properly valued and appropriate duties collected. That seems fair. Customs is exploring ways of ensuring access to the same information from foreign firms that we obtain from American parent firms. For example, in the absence of importer/exporter cooperation, Customs can consider the possibility of appraising merchandise at values as high as the fair market retail selling price when companies refuse to provide needed value information. Or Customs may require live entry and immediate payment of duty until the necessary information is provided.

I understand you are interested in one of our enforcement programs called Operation RAP, which stands for rebate and adjustment program. Operation RAP is our review of what appears to be a common practice of some international cargo carriers to pay importers and sellers rebates for insurance and freight fees. Freight and insurance are nondutiable charges. The overstatement of nondutiable charges fraudulently decreases the dutiable value, causing loss of Customs duties and increases the expenses for tax purposes causing a loss of Federal corporate taxes. This overstatement occurs because freight and insurance companies covertly pay kickbacks to various parties to the import transaction. These kickbacks are not disclosed to Customs.

The catalyst for Operation RAP was an investigation conducted by our Office of Enforcement in 1983 of a foreign auto manufacturer. The company was suspected of overstating the cost of insurance and freight charges. Merchandise sold on the basis of cost, insurance, and freight is also known in the trade as CIF transactions. The investigation concluded with the company paying a civil settlement of $6.175 million, based upon a loss of $4.3 million in duty.

Since then, numerous investigations have been initiated, and from 1984 to the present over $8.8 million in duties and penalties related to overstated CIF charges has been collected.

In order to confront this fraudulent practice, RAP was designated a national fraud project. Initial targets of Operation RAP were Pacific Basin importers. Specific attention was focused on related sellers and importers whose ocean freight shipments were entered on a CIF basis.

A Federal Register notice was published on December 6, 1988, which notified all importers and exporters that they must declare actual freight and insurance charges. The notice also encouraged disclosures and duty tenders. Letters were also sent to approximately 1,400 importers informing them of our investigation.

As a result of the letters and Federal Register notice, 30 importers have disclosed that their CIF charges have been overstated by over $66 million. These importers have made duty tenders exceeding $2 million. An additional $1.3 million in penalties has been assessed.

The purpose of the letters, the Federal Register notice and the investigations is to: stop the practice; collect lost revenue through tenders; prosecute criminally and fine civilly culpable importers.

Two hundred and six formal Operation RAP investigations have been initiated against targeted importers. There has been a high level of cooperation between importers and Customs. In addition to their tenders, some importers have come forward with specific information regarding the practice of freight and insurance rebates. The Customs Service has also recently obtained evidence from the Federal Maritime Commission corroborating the receipt of these rebates by importers. Examples of the evidence obtained includes copies of counter style checks made payable to cash and in some instances named individuals and companies. These checks are drawn from a special account established by an ocean carrier specifically to pay rebates. Some of those checks were cashed in money exchange houses located overseas. Criminal investigations of those importers are in progress.

The investigations conducted to date, as well as information received from both Government and industry sources, suggest that prior to the publicity caused by this operation, that freight and/or insurance on many large, related parties shipments from the Pacific Basin was overstated on CIF importations. Our investigations reveal that the problem is global in nature and not unique to just Pacific Rim importations.

I believe this hearing has been beneficial to the Customs Service. It has made us review practices in the area of audit and our procedures. Together we have reviewed the employment of all the tools we have at our disposal to determine if we are using them properly.

That concludes my prepared remarks. We would be glad to answer any questions you might have.

[The prepared statement follows:]

STATEMENT OF MICHAEL H. LANE, DEPUTY COMMISSIONER
U.S. CUSTOMS SERVICE

Mr. Chairman, I am here today to discuss your interest in the Customs Regulatory Audit Program in regard to related party and transfer price transactions.

As explanatory background, the Office of Regulatory Audit has approximately 300 personnel assigned to 23 field locations and Washington. Their mission encompasses auditing major importers for overall compliance, international trade programs such as the Canada Free Trade Agreement, the Caribbean Basin Initiative, and the Generalized System of Preference all of which afford preferences to imported commodities. In addition, audits of program areas such as drawback, customs house brokers, foreign trade zones, and general importer compliance are performed to ensure the protection of the revenue. Each year, Regulatory Audit performs approximately 600 audits and over the last 5 years has had an average recommended revenue recovery of $56 million.

Throughout its sixteen year history of major importer audits, Customs Office of Regulatory Audit has been auditing an equal share of unrelated and related party transactions. The related party transactions have usually involved american companies maintaining a foreign subsidiary structure. While Customs continues to audit companies which operate on an unrelated basis, an expanded dimension to related party audit verifications has come about because of the increase of foreign firms with subsidiaries in the United States.

With the increase of international trade and the development of the multinational corporation the audit environment has become more complex. At an ever increasing rate, Customs has had to deal with importers and exporters which are related to one another.

The primary concern in all related party transaction audits is to ensure that the prices and values reported for the imported commodities truly reflect all of the transaction in order to ensure proper collection of monies owed to the Treasury. When such companies are audited, Customs focuses on verifying that the relationship between the parent and the subsidiary does not affect the pricing structure. In the unrelated party transaction, the importer who is not related to the supplier contracts to have his merchandise exported to the United States in an "arms length" deal--seller and buyer agree on a price which includes the direct cost of manufacturing, the allocation of overhead, and a profit margin for the supplier or seller.

When the U.S. Subsidiary or the importer is related or wholly owned by the supplier or parent located in a foreign country, or visa versa, that relationship can cloud the objectivity of the value or price of the merchandise. In an arms length transaction, absent fraud, the market sets the price. When there is a relationship there is a question as to the basis for the pricing. Undervaluation of merchandise reduces revenues lawfully due the Treasury. This is true for the company whose parent is located in New York, Chicago, Los Angeles or in London, Amsterdam, or Tokyo.

In any related party transaction, it may be necessary to have access to the records that are maintained by the parent as well as those maintained in other countries by the related subsidiary.

Because Customs has had more exposure to American parent/foreign subsidiary related party transactions over the years we have learned to deal more effectively in this arena. In this case, we have the basic authority and tools to generally obtain the information necessary to make value determinations. Customs has the ability to summon those records necessary to complete the audit process. However, when dealing with the foreign owned and located corporation Customs does not have legal access to records maintained at that foreign parent location. Customs needs access to this information from multinationals regardless of the location of the parent to ensure that merchandise is properly valued and appropriate duties collected. That seems fair. Customs is exploring ways insuring access to the same information from foreign firms that we can from American parent firms. For example, in the absence of importer/exporter cooperation, Customs can consider the possibility of appraising merchandise at values as high as the fair market retail selling price when companies refuse to provide needed value information.

Or Customs may require "live entry" and immediate payment of duty until the necessary information is provided.

If cooperation continues to be not forthcoming in these instances, Customs will seek to deny certain entry facilities for the merchandise involved.

Mr. Chairman, in addition to the Committee's interest in the Customs' regulatory audit issues which I have addressed, I understand you are also interested in one of our enforcement programs called Operation Rap.

Operation Rap, which stands for rebate and adjustment program, is our look into what appears to be a common practice of some international cargo carriers to pay importers and sellers rebates for insurance and freight fees. Freight and insurance are nondutiable charges. The overstatement of nondutiable charges fraudulently decreases the dutiable value, causing loss of Customs duties and increases the expenses for tax purposes causing a loss of federal corporate taxes. This overstatement occurs because freight and insurance companies covertly pay kickbacks to various parties to the import transaction. These kickbacks are not disclosed to Customs.

The catalyst for Operation Rap was an investigation conducted by our Office of Enforcement in 1983 of a large Pacific Rim automobile manufacturer. This company was suspected of overstating the cost of insurance and freight charges. Merchandise sold on the basis of cost insurance and freight are also known in the trade as CIF transactions. The investigation concluded with this manufacturer paying a civil settlement of $6.175 million, based upon a loss of $4.3 million in duty.

Since then, numerous investigations have been initiated, and from 1984 to the present over $8.8 million in duties and penalties related to overstated CIF charges has been collected.

In order to confront this fraudulent practice Operation Rap was designated a national fraud project. Initial targets of Operation Rap were Pacific Basin importers. Specific attention was focused on related sellers and importers whose ocean freight shipments were entered on a CIF basis. The scope of the operation has increased from the Pacific Basin to all geographical regions and now includes all forms of transportation.

A **Federal Register Notice** was published on December 6, 1988, which notified all importers and exporters that they must declare actual freight and insurance charges. The notice also encouraged disclosures and duty tenders. Letters were also sent to approximately 1,400 importers informing them of our investigation.

As a result of the letters and **Federal Register Notice**, 30 importers have disclosed that their CIF charges have been overstated by over $66 million. These importers have made duty tenders exceeding $2 million. An additional $1.3 million in penalties has been assessed.

The purpose of the letters, the **Federal Register Notice** and the investigations is to:

- stop the practice;
- collect lost revenue through tenders;
- prosecute criminally and fine civilly culpable importers.

206 formal Operation Rap investigations have been initiated against targeted importers. There has been a high level of cooperation between importers and Customs officials. In addition to their tenders, some importers have come forward with specific information regarding the practice of freight and insurance rebates. The Customs service has also recently obtained evidence from the Federal Maritime Commission corroborating the receipt of these rebates by importers. Examples of the evidence obtained includes copies of nondescript "counter" style checks made payable to cash and in some instances named individuals and companies. These checks are drawn from a special account established by an ocean carrier specifically to pay rebates. Some of those checks were cashed in money exchange houses located overseas. Criminal investigations of those importers are in progress.

Another example of industry cooperation regards specific information provided in voluntary disclosures. Importers identified three methods by which ocean freight rebates were paid, and two methods by which air freight rebates were paid. Importers stated in their disclosures that payment of freight rebates by ocean carriers had been a common practice and that the amount of rebate paid was determined by industry competitiveness.

The investigations conducted to date, as well as information received from both Government and industry sources, suggest that prior to the publicity caused by this operation, that freight and/or insurance on many large, related parties shipments from the Pacific Basin was overstated on CIF importations. Our investigations reveal that the problem is global in nature and not unique to just Pacific Rim importations. Mr. Chairman, this concludes my prepared remarks. On behalf of Commissioner Hallett I am pleased to be here today and would be happy to respond to any questions you or the other members may have.

Chairman PICKLE. Mr. Lane, thank you. That is an excellent statement. You have given it in a very concise manner. It is a pity you had to wait all day to deliver this to us, but we thank you again.

Earlier today we had met with some representatives of Customs on a panel pointing out some of the particulars of the RAP program. We felt that the information they were establishing through that program is very valuable. They said they had information both from maritime and from other sources.

The question kept coming back to me, once you establish certain facts about a valuable product, whether it is related or not, is that information passed on to the Internal Revenue Service?

Mr. LANE. Frequently it is.

Chairman PICKLE. Frequently.

Do you have an office or an agency in your operation that specifically reports to the Internal Revenue Service? Is there a procedure established to do that?

Mr. LANE. No, sir.

Chairman PICKLE. Why don't we have a procedure so that the agencies will talk to each other on a required basis?

Mr. LANE. I think that it is generally the practice in Customs that if an agent or auditor has information that they believe will impact the IRS, that we provide it to them.

Certainly in the case of RAP we did, we have done that. In the case of some VCR's that I know of, we determined that there was information pertinent to the IRS, we referred to the IRS. I think there is a culture in Customs that promotes that sort of cooperation and information flow.

I mentioned previously that I thought this hearing was good for us because it caused us to examine our own systems and procedures. And in discussing today with individuals you were talking to, I think we will develop a standard operating procedure for providing that information.

Chairman PICKLE. Well, I would hope so.

Specifically, are you able to obtain any information from the Internal Revenue Service that is useful to Customs in its investigation or audits of foreign-owned subsidiaries?

Mr. LANE. No, sir.

Chairman PICKLE. No. You don't have any procedure, do you?

Mr. LANE. No, we don't. We have been meeting with IRS to discuss the possibility of developing——

Chairman PICKLE. Would access to the Internal Revenue Service information be useful to Customs?

Mr. LANE. It would be useful to the Customs Service, yes.

Chairman PICKLE. Have you requested that in writing or have you attempted to set up a procedure between the IRS and Customs so that you can exchange that information?

Mr. LANE. We have met with IRS. They were very helpful and suggested that they would see what they could do to provide more information.

One, they would see what could be provided within the law.

Second, they would review the possibility of providing a legislative change under 6103. I don't know what the status of that is right now.

Chairman PICKLE. Well, do you have any reason to suspect that foreign-owned subsidiaries report different information to the Internal Revenue Service for tax purposes, Commerce for any dumping purposes and Customs for duty purposes?

Mr. LANE. I am not sure if that is the case or not. I don't know that——

Chairman PICKLE. My question is, do you have any reason to suspect that this is going on? Surely the answer would be, yes, you wouldn't be conducting RAP if there wasn't any——

Mr. LANE. Frequently we have this happening. They will lie to us, even over pay duty to the Customs Service, in order to get, avoid a dumping case by the Commerce Department. So that they overvalue the merchandise, they will overpay duty in order to provide inaccurate information to Commerce.

In that case, they are lying to both the IRS and Customs. In our case, we are getting additional duties.

Chairman PICKLE. Well, I am sure there are cases and there probably will be a lot more cases as you go along. I am trying to study the degree or the extent of information between the two agencies.

Our staff says in many instances the Federal agencies are not talking to each other.

Mr. LANE. I think that is exactly right. In the case of IRS, we talk to them. They can't talk back to us. We are trying to address that.

I think in the case of Commerce, there is a good flow of information back and forth. Maybe it is not as good as it should be. We are trying to improve on that.

In the case of the Federal Maritime Commission, I think we have been pretty successful. I think it would be appropriate to review that as well.

Chairman PICKLE. I think if we can specifically take actions in some of those areas, I think the Congress, this committee, could help inaugurate those procedures and make suggestions.

We intend to do that because we think it would be very helpful.

I think it was interesting, according to your testimony, that you put a Federal Register notice out that everybody has to declare their actual freight and insurance charges. That got results, didn't it?

Mr. **Lane**. Yes, it did.

Chairman **Pickle**. Are you satisfied with their declarations?

Mr. **Lane**. No, sir. We are continuing to investigate. We have had a lot of voluntary disclosures, voluntary tenders, but we still have over 200 open investigations. We think that we have made progress in stopping this type of violation, but we don't think that all companies have complied. We are still continuing to investigate.

Chairman **Pickle**. You do say, though, that both freight and insurance, since they are not dutiable charges, are being used to a large extent, particularly in the rebate field, to avoid taxes?

Mr. **Lane**. Yes, sir.

Chairman **Pickle**. Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman.

Mr. Commissioner, we today received some troubling testimony about several very complex duty and tax avoidance schemes. Do you feel that Customs is devoting enough services pursuing the commercial fraud and duty avoidance?

Mr. **Lane**. I think we are devoting a reasonable amount of our resources to that. Out of the total that we have available to us, I think we made a wise commitment of our resources.

Mr. **McGrath**. If you could put more resources in this area, do you have any estimate of how much additional revenues could be raised through increased Customs audits? How about increased fraud investigations?

Mr. **Lane**. Well, I don't think we have reached the limit of our success.

I think we could add substantially to our audit and fraud efforts and still bring in revenues. I know, for instance, that in the area of fraud audits, our auditors are bringing in a ratio of 14-to-1, their salary versus their returns on fraud cases.

So, we think there are a lot more that they can be doing.

Similarly, our investigators are very good and accomplished in this area and probably adding more new fraud investigations. We could probably bring in more revenue and more penalties.

Mr. **McGrath**. I understand that Operation RAP was started as the result of the Toyota settlement?

Mr. **Lane**. That is correct.

Mr. **McGrath**. Why would companies voluntarily enter into such a settlement agreement?

Mr. **Lane**. Well, it sort of, these agreements are reached to accommodate both parties. The company knows it has some vulnerability and the Government knows that it has some litigation risk, and a limited amount of resources to put into them and perhaps other vulnerabilities.

Usually what happens, at some point a company will make a voluntary tender and it is deemed in the best interest of the Government and the company to come to accommodation——

Mr. **McGrath**. How much in that particular settlement was originally for Toyota? How much did you eventually settle on?

Mr. **Lane**. The loss of, the duties, I think, the loss of revenue was around $4 million. The penalty, I believe, was $2 million.

Mr. **McGrath**. Why didn't you go for the full amount, seeing that you caught the company redhanded?

Mr. **Lane**. Well, there are in cases, where we are going to come to an out-of-court settlement—and I heard the IRS testimony, frequently Customs does go to court in criminal cases and civil cases. We have gotten convictions.

We believe that helps the process.

In this case and in all cases, we have to look at mitigating factors as well as aggravating circumstances. And having done that, we believe that this was an appropriate settlement. The settlement in this case was gross negligence, not fraud. There is sort of a formula that we used.

This was it, within the bounds of that, considering the mitigating factors.

Mr. **McGrath**. Mr. Chairman, at this point I would ask that a copy of the Toyota settlement agreement be placed in the hearing record.

Chairman **Pickle**. Without objection.

[The information follows:]

Agreement of Civil Settlement
Between the United States of America and
Toyota Motor Sales, U.S.A., Inc.

This Agreement of Settlement (the "Agreement") is between the United States of America (the "Government"), represented by the United States Customs Service, and Toyota Motor Sales, U.S.A., Inc. (the "Company").

WHEREAS, in the Government's view, the Company may not have complied with all requirements of law, and such acts of potential non-compliance in the Government's view could result in the imposition of additional Customs duties and the imposition of civil penalties against the Company, pursuant to proceedings under section 592, Tariff Act of 1930 (19 U.S.C. §1592);

WHEREAS, the Company denies any wrongdoing in connection with the importations described more fully herein and has advised the Government that the Company considers the entire payment set forth herein as payment of duties and not payment of any penalty arising under section 592, the company nevertheless agrees that it is in the best interest of the Company to enter into this Agreement; and

WHEREAS, the Government has conducted investigations into the facts of the transactions and agrees that it is in the best interest of the Government to enter into this Agreement.

NOW THEREFORE, it is agreed that the claims or potential claims of the Government, as more fully described hereinafter, be settled and compromised as hereinafter expressly set forth, on the following terms and conditions:

1. Upon execution of this Agreement by the Government, all claims and potential claims of the Government for penalties and duties under section 592 of the tariff act, which relate to the Company's importation of motor vehicles into the United States during the period of July 1, 1980, through April 30, 1984, are released, satisfied and extinguished as to the Company, its parent, subsidiaries, predecessors, successors, affiliates, divisions, directors, officers, employees, and agents.

2. The Government agrees that any ongoing investigations will be terminated and that no further investigations will be commenced with respect to the importations at issue.

3. The Company acknowledges that with respect to the importations described in this Agreement, the Company, its parent, subsidiaries, predecessors, successors, affiliates, divisions, directors, officers, employees, and agents waive any and all statutory and administrative rights under the Customs laws, the Customs Regulations and under other applicable federal laws or regulations to which they may otherwise be entitled, including their rights to

A. A pre-penalty notice, setting forth:
   - (i) a description of the merchandise;
   - (ii) the details of the introduction of such merchandise;
   - (iii) the laws violated;
   - (iv) the material facts establishing the violation;
   - (v) a statement whether the violation occurred as a result of fraud, gross negligence or negligence;
   - (vi) the estimated loss of lawful duties; and
   - (vii) a statement informing them of the opportunity to make representations as to why the Government's claim for monetary penalty should not be issued (19 U.S.C. 1592(b)(2) and 1618).

B. A written penalty claim, specifying any changes in the information listed in A above.

C. The right to petition for remission or mitigation of the monetary penalty (19 U.S.C. 1592(b)(2) and 1618).

D. A written statement setting forth the final determination, including findings of fact and conclusions of law (19 U.S.C. 1592(b)(2).

E. Trial in the Court of International Trade, where all issues, including the amount of the penalty, would be tried *de novo*.

4. The Company acknowledges that the settlement of civil liabilities under this Agreement is made exclusively under the authority of the Customs Service to act for and on behalf of the Secretary of the Treasury under section 617 of the tariff act (19 U.S.C. §1617).

5. Nothing in this Agreement shall preclude the Customs Service from taking appropriate action (including the issuance of civil penalties) against the Company, its parent, subsidiaries, predecessors, successors, affiliates, divisions, directors, officers, employees, and agents, with regard to any importations of merchandise not specifically covered by this Agreement.

6. Upon execution by the Government of this Agreement the Company shall cause to be delivered to the Government, a check in the sum of six million, one hundred and seventy-five thousand dollars ($6,175,000), payable to the United States Treasury, on or before December 5, 1986, representing the full and complete settlement of all claims and potential claims of the Government, under the Customs laws of the United States.

7. This Agreement shall bind and inure to the benefit of the parties hereto, their officers, directors, employees, predecessors, successors, parents, affiliates, subsidiaries, heirs, executors, administrators, agents and assigns.

8. The Company and the Government each represents and warrants that it has the full right, power, and authority to execute and deliver this Agreement and that no approval or authorization by any other person is required for this Agreement to be binding on such party.

Dated: December 5, 1986

Toyota Motor Sales U.S.A., Inc.

By
President

The United States of America

By Donald W. Lewis
Director, Entry Procedures
and Penalties Division

Mr. **McGrath**. I understand that Operation Tin Lizzie is looking in part at possible ways to abuse the Canada Free Trade Agreement.

If games can be played with the Canadian agreement, what implications does that hold for the enforcement of a possible Mexican FTA?

Mr. **Lane**. Well, we are just beginning now as part of the Federal effort led by USTR/Treasury/Commerce to look into the ramifications of a free trade agreement with the Mexicans. We certainly—I guess the Mexicans are our third largest trading partner.

There is a great deal of action right now, increased trade along our borders. There is a different culture and environment down there. We will have to, we are examining that right now, Congressman.

We couldn't really say at this point what the impact of that will be.

Mr. **McGrath**. Are there any contemplated antidumping cases being brought as a result of Operation Tin Lizzie?

Mr. **Lane**. Not that I know of. As you know, the Commerce Department handles those now rather than the Customs Service.

When they make the determination, we do the enforcement.

Mr. **McGrath**. As I understand it, the parts being shipped to Canada for assembly cost more than what the cars are being sold for in the United States. Would that constitute an antidumping case?

Mr. **Lane**. I am not quite sure I understand that.

Mr. **Rosettie**. We are not sure of the data on which that, the question would be based on. It looks to us like that is a possibility.

The north-bound parts seem to be at a very high cost. But it is a very preliminary level of that audit, we are about 25 percent into the records.

If it were to hold up with that ratio, then it would create an environment where a dumping case would be an appropriate response, assuming there is a complaint, assuming the injury test is met and all the other things that go with a dumping case.

Mr. **McGrath**. The complainant could be the Department of Commerce? Am I correct?

Mr. **Rosettie**. I don't know if they self-initiate. Generally I think in the present time there would be another producer that would complain about that situation. They would actually bring the action.

Mr. **McGrath**. Does Customs self-initiate the case? Is there any prohibition against Customs doing so?

Mr. **Rosettie**. In 1979 or 1980, we lost the authority to do that, sir.

Mr. **McGrath**. One of the complaints we have heard is that both IRS and Customs lack access to useful records of foreign parent corporations. Would legislation be useful permitting access to parent corporation records?

Mr. **Lane**. Well that is one of the things that we would have under consideration on our list of things that might be needed. Congressman, right now as a result of your interest in this we are looking into all of the tools and remedies that we currently have at our disposal to make sure that we are using them properly.

After that we are going to look at the potential legislative requirements that we might have.

Mr. McGRATH. Commissioner, since you work at the policy level I would like to ask you about your knowledge of the Customs-IRS relationship. What is the status of the memorandum of understanding between Customs and the IRS? It is our understanding that negotiations have broken down.

Mr. LANE. That is not the case, Congressman. Negotiations really have not broken down and we have not been working toward a good cooperative environment.

I believe that the relationship is good, at least from the IRS standpoint, we give them whatever we can.

Mr. McGRATH. How about going the other way?

Mr. LANE. They are prohibited from doing that.

Mr. McGRATH. Do you feel you need access to some of the section 6103 information?

Mr. LANE. Yes, we do.

Mr. McGRATH. Is there a possibility that Customs could qualify under current law exemptions in section 6103?

Mr. LANE. I am not sure. Commissioner Goldberg stated that they were looking at that. We hope they would report favorably. I am not confident that they will. We would also hope that if it is not permissible that at least the consideration of legislation would be looked at by the IRS.

Mr. McGRATH. In the absence of the any memorandum of understanding or any other kind of understanding that has developed between your agency and the IRS I wonder whether you could provide for the committee any legislative remedies that you think might be helpful in carrying out your responsibilities.

Mr. LANE. Yes, sir.

[The following was subsequently received:]

The Customs Service has no recommended legislative language to offer at this time. Customs is working diligently with the IRS and the Treasury's Office of Tax Policy to develop solutions to this complex problem. This problem resolution process as noted previously will include either a letter or memorandum of understanding in the near future. Customs would be pleased to supply the subcommittee with a copy of this document once it has been finalized.

Mr. McGRATH. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you.

Mr. Deputy Commissioner, we have one or two more questions. I have here a memorandum I will ask to have submitted for the record. That is a memorandum that we obtained from the Internal Revenue pertaining to the understatement of product values. It describes a meeting between the IRS officials and an informant who was a former employee of a large foreign-owned subsidiary. It describes a method allegedly used by this company to understate product values to Customs and overstate them to the IRS.

The informant alleged that "the company undervalued the merchandise being imported into the United States so as to minimize its Customs duty fees and then increased the cost to the United States entity and increased the profit to the Japanese parent by a series of intercompany charges."

The memorandum states that the informant knows these charges should be included in the Customs declaration when in fact they were not.

[The following was subsequently received:]

INTERNAL REVENUE SERVICE

MEMORANDUM

DATE: [redacted]

TO: FILE

FROM: [redacted]

SUBJECT: Minutes of meeting with [redacted], Informant on [redacted]

In attendance were: [redacted] Case Mgr. on [redacted]
[redacted] Coordinator on [redacted]
[redacted] Informant

The following statements were made by [redacted] in response to questions posed to him and other information he voluntarily offered regarding allegations of wrongdoing by [redacted]. He was employed by [redacted] at the [redacted] office from [redacted] His title was that of [redacted] His responsibility was that of ensuring that merchandise came into the country and out to the distribution centers. He was responsible for "customs clearance" in [redacted] His direct supervisor was a [redacted] He discovered in or [redacted] that the company's practices in the import activity were questionable with regard to U.S. Customs violations and in violation of IRC Section 1059A, to "the best of his understanding". Specifically, he alleges that the company undervalued the merchandise being imported into the U.S. so as to minimize its Customs duty fee, and then increased the costs to the U.S. entity [redacted] and thereby increased profit to the Japanese parent, by a series of intercompany charges. Intercompany Debit Advices are on file for the respective accounts charged.
He assumes that these charges are not substantiated for tax purposes and he "knows" that they should be included in the Customs declaration when in fact they were not. As examples of these intercompany charges he mentions: advertising, technical services, royalties, trademark, engineering, R&D, etc.. He did not see these intercompany debit advices that he alleges were used, but heard about them from a colleague in the Accounting Dept., and in fact did see a summary listing of them on a computer run. (of intercompany charges)

At about the same time, he wrote all of the above in a memo adressed to corporate counsel [redacted] in a "draft form" and he gave to his boss [redacted]. [redacted] told [redacted] that he would "check this out with corporate attorney [redacted] and get back to him [redacted]. Three days later, [redacted] told [redacted] to destroy the memo and that an attorney from corporate counsel would look into his allegations. The attorney assigned was a [redacted].

He also discussed the situation with the comptroller [redacted] who also had concerns re:violations. He spoke to the head of the tax dept. [redacted] at a cocktail party. [redacted] told him that this was already checked out in [redacted] and that there was no problem. He also told a [redacted] manager in the tax dept., who expressed his own concerns regarding the situation.

He asked attorney [redacted] about the status of her inquiry one month later, and she replied that "this had become a back burner issue and you should not worry about it".

[redacted] acquired a company called [redacted]

He also advised in a memo [redacted] that there were many violations of duty regulations in the [redacted] acquisition.

Two weeks after writing this memo, while he was on a trip to Japan on business, he was brought up on "trumped up sex harassment charges" by a subordinate woman employee. On his return to the U.S. he was fired.

[redacted] has contacted U.S. Customs but has not been interviewed by them to date.

He has been employed by the [redacted] since [redacted].

To illustrate a scenario of his allegations he gave the following example:

He would receive an advance notice of a shipment of merchandise coming into the U.S.. The commercial invoice would have the minimum arm's length value to avoid customs duty. After the merchandise cleared Customs, the price would be adjusted up by way of the previously mentioned intercompany charges. He has nothing to substantiate these claims, and he never saw any of the debit advice memos but learned of these through his association with accounting personnel and saw a summary listing of these charges. His allegations were confirmed by the comptroller, [redacted] who was also concerned about it.

[redacted]

Prior to his employment, his position was held by a [redacted] who was then transferred to [redacted] to a similar position.

[redacted] also feels that the company tried to entrap him by having a fellow male employee named [redacted] meet him in [redacted] on his return trip from Japan, along with two female companions who invited him to the hotel for some drinks...... [redacted] refused the offer but was later told by the company that they were aware that "he had propositioned two women in [redacted]".

[redacted]ed suit [redacted] made a settlement offer but wanted a provision in the contract to state that [redacted] would make no disclosures to any Government Agencies. [redacted] declined the settlement offer.

He has not told his attorneys that he is meeting with the IRS.

He feels that the practices of incorrect values placed on imports were going on prior to his employment at [redacted] and are still going on.

[redacted] is willing to be interviewed by IRS Counsel if necessary.

He inquired about a reward for his assistance and was told that an inquiry would be made about the procedures and criteria.

Chairman PICKLE. Are you aware of these kinds of practices?

Mr. LANE. Yes, sir.

Chairman PICKLE. Are you aware of this particular memorandum?

Mr. LANE. I was given it right before the hearing, so we have not had a chance to look at it.

Chairman PICKLE. What can Customs do to stop it?

Mr. LANE. We think we are doing a lot to stop that sort of thing. Operation RAP is one method. The convictions that we have had in criminal cases where people have been personally liable and faced jail terms, the civil liabilities that we have had and huge penalties, I guess seven and eight figure penalties that we have had against companies and the actions that we have taken with the establishment of the Commercial Fraud Enforcement Center and the multidiscipline teams I think are things that deter companies from doing that and also help us catch them when they do.

We think there is a lot of fraud and we are continuing to pursue it.

Chairman PICKLE. You made a record of that in your statement. It is my understanding that Customs has discovered that ocean carriers and international insurance companies are clandestinely paying rebates to foreign-owned subsidiaries. Are those foreign-owned subsidiaries reporting these rebates to Customs?

Mr. LANE. No, sir.

Chairman PICKLE. How do they hide the rebate? Can you tell me?

Mr. LANE. My understanding is they use a scheme similar to what money launders use. They have a variety of schemes. Special Agent Esau is sort of an expert on this.

Mr. ESAU. The payments if they are made to the foreign parent just ordinarily are not available to us. We have to root them out investigatively. Often the domestic subsidiary is not aware of them unless they are made to the domestic subsidiary.

Chairman PICKLE. Are they paid in cash?

Mr. ESAU. They are paid in cash——

Chairman PICKLE. Counter checks?

Mr. ESAU. They are made in counter checks made out to cash, made out to an individual person, they are made out in claim checks.

Chairman PICKLE. We are advised they might be written against offshore banks or businesses, correct?

Mr. ESAU. Yes, sir. In almost every way they are negotiated in the same way as instruments in narcotics money laundering.

Chairman PICKLE. How many foreign-owned subsidiaries do you estimate are engaged in this scheme?

Mr. ESAU. We have over 200 open formal investigations, sir.

Chairman PICKLE. In other words, several hundred are actually involved in this scheme?

Mr. ESAU. That we currently suspect, yes, sir.

Chairman PICKLE. Do you have a concentrated ongoing investigation of this practice?

Mr. LANE. Yes, sir, we have a national fraud investigation of this.

Mr. **McGrath**. One of the suggestions the IRS made, you were here during that questioning, was that there be an addendum to the tax return outlining how they arrived at their transfer price scheme showing all the information required in order to justify the price.

Would that kind thing or something similar be helpful in determining whether or not we could investigate this kind of fraud?

Mr. **Lane**. Yes, sir, that is the kind of thing we would have on our list of things that would help us make the proper determinations.

Mr. **McGrath**. Thank you.

Chairman **Pickle**. Well, Commissioner, again I want to thank you for staying with us and for giving us testimony that has been very helpful. We enjoy working with you and the Customs Commissioner.

You have made some changes over there.

We will resume our hearing on this 482 question on Thursday morning at 11 at which time we will be hearing from Members of the Congress. We will be hearing from the Treasury Department.

We will stand adjourned until Thursday at 11 a.m.

[Whereupon, at 6:40 p.m., the subcommittee was adjourned, to reconvene at 11 a.m., Thursday, July 12, 1990.]

TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES

THURSDAY, JULY 12, 1990

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 11 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

Chairman PICKLE. The Chair will ask the subcommittee to please come to order.

On Tuesday, this subcommittee held 9 hours of hearings to examine whether foreign-owned subsidiaries are paying their fair share of U.S. income taxes. Unfortunately, the answer we have heard from morning to evening was a resounding "no," they are not.

Tuesday, I asked how could a company owned by a profitable foreign multinational which has been very successful in marketing its products in this country continue, year after year to report losses and still stay in business. Now we know the answer—by gaming the tax system. Many of these companies are engaged in what appears to be deliberate tax avoidance schemes of inflated transfer pricing, of excessive expense deductions, and by profit and loss patterns to wipe out any tax paid with net operating losses. The United States is a free market society, but it is not a tax-free society. Corporations are expected to shoulder a proportionate share of their country's revenue needs. Under payment of tax by these companies is simply intolerable.

The subcommittee's 9-month investigation which was concentrated on 36 foreign-owned companies in the automobile, motorcycle and the electronics equipment industries, uncovered companies that have been operating in the United States for years and have never paid Uncle Sam one thin dime of Federal taxes despite billions of dollars of U.S. sales of cars, stereos, automobiles, motorcycles and the like. But they should be paying taxes and would be paying taxes if they were complying with our Federal tax laws. Many are shifting income from the United States and continue to do so despite repeated examinations by the Internal Revenue Service.

Tuesday, we heard Commissioner Goldberg testify there is a serious compliance problem here and that the IRS is being "outgunned" by multinational corporations and their high-priced representatives. I do not believe that the IRS now is currently equipped to handle or is able to effective protect this country's voluntary tax system against transfer pricing abuse.

The misallocation of profits among foreign multinationals and their subsidiaries will continue to present monumental problems unless and until the IRS has a more effective and efficient international enforcement program.

On Tuesday, we learned that these companies are not just a problem for IRS, but also for Customs as well. We heard of cases where foreign-owned corporations improperly shifted income from the United States through schemes st up to avoid Customs import duty. Some companies have been caught by Customs illegally reducing their duty payments through fraudulent shipping and insurance charges, through kickbacks, and manipulation of prices of products traded between subsidiaries operating in the United States and in other countries.

We must continue to ask whether the Federal Government is getting whipsawed and whether the Federal Government is in control. We need to continue to ask whether these agencies have the enforcement tools they need to get the job done.

There is no better person to be asked that question than our first witness today, Hon. Ken Gideon, Assistant Secretary of the Treasury for Tax Policy. We continue to hear that no one in the IRS or Treasury knows the exact amount of revenue at stake. I propose we are talking about billions, perhaps in the range of $30 billion.

This estimate assumes that foreign-owned subsidiaries in the United States pay tax on profits of 8 to 10 percent as was testified by the Internal Revenue agents in the field—we are using their figures—somewhere in the profit range of 8 to 10 percent like U.S. firms are paying on their operations overseas. I have data that I will present to the committee later on the facts given to us by the IRS.

We will also hear from Members of Congress interested in this issue, from representatives of the Commerce Department, and experts in the field of international taxation and economics.

I look forward to hearing what they have to say about the problem that we brought to light publicly on Tuesday and I thank all of you for being here and for showing your concern.

[An attachment to Mr. Pickle's statement follows:]

Controlled Foreign Corporations of U.S. Corporations: Selected Items, by Selected Countries, 1980, 1982, 1984, and 1986

[Money amounts are in millions of dollars]

Year/ Country	Number of U.S. Corps.	Number of CFC's	Totals Assets	Business Receipts	Current Earnings and Profits Before Taxes	Foreign Income Taxes	Current Distributions
1980, Total......	4,799	35,471	508,032	699,003	47,622	16,440	14,116
Canada..........	2,527	5,415	90,044	100,773	8,285	3,143	1,900
United Kingdom..	1,557	5,031	75,917	99,113	8,034	2,528	2,121
West Germany....	987	2,049	46,151	72,488	4,891	2,279	1,670
Japan...........	423	595	10,215	16,175	1,497	694	378
1982, Total......	1,034	26,993	557,209	647,877	36,696	14,077	14,650
Canada..........	734	2,899	91,100	102,394	5,346	1,942	2,674
United Kingdom..	610	4,133	83,330	99,337	7,762	3,124	2,665
West Germany....	434	1,463	45,909	65,206	3,020	1,481	1,255
Japan...........	242	431	10,378	16,659	978	566	318
1984, Total......	1,103	27,008	595,406	624,530	48,592	19,663	17,429
Canada..........	761	7,840	99,796	117,740	10,886	4,195	3,547
United Kingdom..	634	4,135	83,826	96,419	11,508	5,771	4,803
West Germany....	425	1,455	43,968	59,558	2,762	1,381	1,058
Japan...........	280	489	12,466	19,244	1,507	831	535
1986, Total......	919	27,016	774,423	630,330	59,545	20,172	23,670
Canada..........	637	2,673	115,339	108,333	9,024	3,550	3,572
United Kingdom..	573	4,485	151,351	102,536	10,342	3,593	5,020
West Germany....	406	1,466	66,332	72,166	5,639	2,732	1,974
Japan...........	269	564	20,410	28,816	2,814	1,516	1,009

Source: SOI Division, Internal Revenue Service
July, 1990

NOTES TO TABLE

The accompanying table shows financial information for controlled foreign corporations (CFC's) of U.S. corporations. However, different criteria were used for inclusion in the different study years.

- -In 1980, data were gathered for all CFC's controlled by U.S. corporations in the SOI sample.
- -In 1982 and 1984, data were gathered for CFC's which were controlled by U.S. corporations with $250 million or more in assets.
- -In 1986, data were gathered for CFC's which were controlled by U.S. corporations with $500 million or more in assets.

Although the studies were smaller in scope for 1982, 1984, and 1986, the data contained in those studies are estimated to represent over 95 percent of financial information for all CFC's.

The countries shown are the country of incorporation of the CFC's. CFC's may have conducted business outside their country of incorporation.

DEFINITIONS OF SELECTED TERMS

Business receipts. In general, this term refers to gross sales less certain allowances. This definition differs from business receipts of domestic corporations because it includes investment income.

Current earnings and profits. These are calculated under U.S. accounting principles as required by the Internal Revenue Service.

Foreign income taxes. These include income, war profits, and excess profits taxes. These may have been paid to other countries in which the CFC conducts operations.

For additional information, contact John Bradford on 233-1712.

Chairman PICKLE. Mr. McGrath, do you have any opening statement?

Mr. MCGRATH. Mr. Chairman, I join you in opening our second day of hearings on the tax payments of U.S. subsidiaries which are controlled by foreign owners.

On Tuesday, we heard testimony which tended to confirm our worst fears.

The evidence shows that numerous foreign-owned subsidiaries are paying only a negligible amount of income tax despite sharply increasing gross receipts.

The principal reason for the abnormally low-income tax payments is that the foreign parent overcharges its U.S. subsidiary for the product being sold in the United States.

The result is that the U.S. subsidiary barely breaks even, whereas the foreign parent reaps the entire profit.

In addition to inflating the transfer price to the subsidiary, the foreign parent also may impose extra costs on its subsidiary without properly adjusting the transfer price. Such extra costs could arise from advertising payments, rebate incentive programs or fulfilling warranty obligations.

Each of these activities can involve significant amounts of money, but the U.S. subsidiary may be forced to absorb these costs without proper compensation.

In every day language, these are the ingredients used to cook the books. These are the tools which the foreign parent uses to bleed income from its U.S. subsidiary.

The manipulation of transfer pricing is an old tactic for shifting income between commonly controlled companies. So what is the difference now? The difference now is that the scale of tax avoidance may have grown significantly. The potential abuse has grown in proportion to the growth in the global marketplace.

We are no longer dealing with domestic companies trying to shave their income a little to avoid high State income taxes. We are dealing with global corporations which may try to manipulate around the income tax of an entire Nation.

How should we address the problem?

An important policy question is whether we should improve the application of the transfer pricing rules under section 482, or whether we should explore an entirely new approach.

The correct answer may be all of the above.

In the short term, we should improve the operation of transfer pricing rules under section 482, but this may be more of a stopgap measure than a long-term solution.

Our witnesses today can help us round out the story we heard on Tuesday. What is the cause of the ineffective operation of section 482? How can we make it work better? What alternatives exist that may replace section 482?

Mr. Chairman, the subcommittee can benefit greatly from today's testimony and I join you in welcoming our witnesses.

Chairman **Pickle**. Thank you, Mr. McGrath.

Do other members have opening statements?

Mr. **Dorgan**. Briefly, let me especially commend the chairman of this subcommittee.

This is an extraordinarily complicated issue and the chairman has been determined in pursuing it.

I think what we have here is sort of the grand daddy of tax avoidance.

We have a substantial amount of tax avoidance and we have to try and figure out what to do about it.

Somebody asked me yesterday, "After what you have heard, do you think that some of the companies have been underpaying their taxes?"

I said, "I tell you what, there is no other conclusion left to anybody looking at the facts here."

When there's so much money that appears to not have been paid in taxes that should be paid, you have to find a way to deal with it.

It is always, it seems to me, incumbent on companies doing business in new jurisdictions, whether States or countries, to subscribe to the understanding that they are expected to meet their tax responsibilities when they begin doing business in those areas.

It seems to me that systematically there has been massive tax avoidance in this area. And I am happy that Secretary Gideon is here today so that we can talk about these areas and talk about how to set this right and fix the problem.

Mr. **Anthony**. Mr. Chairman, I notice that the Appropriations Committee has added an additional $10 million over and above some $600 million for the IRS, the $10 million specifically being to encourage the Service to do more extensive audits under section 482.

So it appears that our concern and our hearings have already triggered some positive results.

I have been trying to glance through Mr. Gideon's testimony and I don't know if he has any statement about that additional money, but if you would, Mr. Gideon, in your testimony, please address what you are likely to be able to do or what is likely to be able to be accomplished with the additional $10 million. Also please address whether or not that is sufficient and whether or not this committee should consider recommending additional funds.

Chairman PICKLE. Thank you, Mr. Anthony.

Mr. Shaw.

Mr. SHAW. Very briefly, Mr. Chairman, I would like to compliment you and the ranking member and our able staff for exposing something that can be described as nothing less than an absolute outrage. We have so many foreign companies doing business in this country which have totally dominated some industries such as the electronics and camera industries and the automobile industry but we now find that the majority of them are not paying taxes under the U.S. law.

We talk about tax avoidance. There is nothing wrong with tax avoidance if it is done legally under the law. But when it becomes tax evasion, then it becomes not only fraudulent but fraudulent to the extent that I believe in many cases what we have here is criminal conduct.

I believe a lot needs to be done. We are going to have to examine existing law very carefully as well as the question whether we are spending enough on our IRS examiners.

I made the statement last Tuesday and I will make it again. I believe that if many of our own domestic corporate executives here in the United States had made the same decisions and their conduct was similar to that of many of these foreign corporations who are guests doing business here in the United States, that they would well be in jail.

It wouldn't be a question of whether or not they were paying penalties or interest, but a question of how many years they were to serve in Federal prison.

We need to be aggressive in attacking this problem. We have literally billions and billions of dollars out there that have not been taxed.

When you look at the tremendous profits that have been made that have been glossed over because of cooked books, it is an outrage to the American taxpayer, in cooperation with the IRS and Treasury, we must attack this problem aggressively and see that the problems that have been created perhaps by loose laws, perhaps by underfunding of the Internal Revenue Service or whatever it is, not only be cleaned up, but that we leave an environment where this could not allow tax evasion by any of our foreign corporations.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Shaw.

Mr. Gideon, we are glad to have you here this morning. We are pleased to hear from you.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY LOWELL DWORIN, DIRECTOR, OFFICE OF TAX ANALYSIS

Mr. Gideon. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, it is a pleasure to be here today to discuss tax compliance issues presented by the operation of foreign-owned businesses in the United States.

We understand that this subcommittee is particularly interested in whether U.S. subsidiaries of foreign companies are paying their fair share of U.S. tax.

This is part of the broader issue of related company transfer pricing problems that arise under Internal Revenue Code section 482.

Let me introduce Lowell Dworin, the Director of the Office of Tax Analysis, who is with me at the table.

If we get into the data, I may turn to Lowell at some point later in time.

I have a more lengthy statement and ask that it be included in the record.

Chairman Pickle. Without objection, we hope that you will go into whatever detail you wish at this time.

Mr. Gideon. Thank you.

In the Tax Reform Act of 1986, Congress amended section 482 to address particular difficulties presented by the transfers of intangible property.

At that time, Congress indicated its particular concern with cases involving outbound transfers by U.S. companies of highly profitable intangibles to offshore affiliates where the payments returned to the United States were insufficient.

The focus of this subcommittee today raises questions about inbound transfers of goods, technology, and services. It is the reverse of the problem on which Congress focused in 1986.

This contrast, though, illustrates an important principle—any changes to our methods for determining the fair distribution of income among affiliated entities must be balanced and reasonable.

Overaggressive rules to prevent perceived abuses in cases of outbound transfers by U.S. companies could seriously jeopardize our tax collections from the inbound investments of foreign companies.

Overaggressive rules regarding inbound transfers could boomerang to produce insufficient returns on outbound transfers.

In addition, given the magnitude of U.S. investment abroad, we must be fair in taxing inbound investment because we must expect, and be willing to accept, similar measures imposed by foreign jurisdictions on U.S. investment abroad.

Attached to my written testimony are four exhibits which set forth economic data drawn from 1987 tax returns as compiled by the Statistics of Income Division of the IRS and analyzed by Treasury economists.

Exhibit 1 presents information on the gains and losses of foreign-controlled and U.S.-controlled corporations, as measured by total receipts less total deductions.

It also presents information on the assets of these companies and on the tax accounting rate of return for each of the industries in which this subcommittee has expressed an interest.

The statistics presented in exhibit 1 generally indicate that the low overall profitability does not reflect uniformly poor performance by all foreign-controlled U.S. corporations.

Rather, some foreign-controlled U.S. corporations are as profitable as many U.S.-owned firms. However, the proportion of firms that incure losses is higher for foreign-controlled firms.

This overall tendency is present in most, but not all, separate industries.

In exhibit 2, the ratios of gross profit to gross receipts are noted.

If foreign-controlled corporations pay their related foreign suppliers more for the goods acquired than would be paid in an arms-length transaction, this would be consistent with a lower gross profit ratio.

Exhibit 2 shows that the gross profit ratios for foreign-controlled corporations are indeed much lower than those for U.S.-controlled corporations.

To explore whether foreign-controlled corporations might engage in greater earnings stripping, that is, the reduction in taxable income through the use of leverage, especially debt provided by related creditors, the ratios of their interest expense to their net income before interest and to their assets are noted in exhibit 3.

Because the interest expense used in these calculations is interest paid to all creditors, and not just interest paid to related creditors, these ratios suggest, but do not confirm, utilization of earnings stripping.

Finally, exhibit 4 provides information on the total receipts, the total tax liabilities, after credits, and the ratios of the tax liabilities to total receipts reported by foreign- and U.S.-controlled corporations.

On average, foreign-controlled corporations paid less taxes per dollar of receipts than did U.S.-controlled corporations.

It might be tempting to infer from these data alone that foreign-controlled U.S. firms are practicing aggressive transfer pricing.

Why, otherwise, would they accept such apparently unattractive rates of return on their invested capital?

However, the interpretation of data such as that included in exhibits 1 to 4 must be done with extreme caution.

While aggressive transfer pricing may be one explanation, other factors such as startup expenses, acquisition indebtedness, the age of the investment, the experience and skills of the management, the specific type of product being produced, and the nature of the manufacturing process also affect the observed returns.

Chairman PICKLE. Mr. Secretary, I am having difficulty listening to you and trying to follow your written comments that you submitted to the committee.

I can't find reference to the exhibits and I don't know at what point you are testifying.

Will you try to keep us advised where you are so that we can follow your script?

Mr. GIDEON. OK.

I am on page 6, and moving on to—just discussing the conclusions that are expressed on the bottom of page 6.

Chairman **Pickle**. All right.

Go ahead, Mr. Secretary.

Mr. **Gideon**. The bottom line being, careful analysis of detailed firm specific data is needed to reach that conclusion.

Still, on the basis of aggregate figures, it is certainly justifiable to conclude that transfer pricing practices of many foreign-controlled U.S. firms should be carefully scrutinized.

Each comparison of related party transactions to the arms-length norm requires a thorough analysis of all the relevant facts and circumstances.

Two factors are essential in order to process these cases: a significant commitment of personnel and broad access to the relevant data.

We believe that major progress has been made in recent years with respect to both of these factors.

As Commissioner Goldberg explained, the IRS has for several years been increasing its review of foreign-owned companies, with particular emphasis on the transfer pricing practices of those companies.

We are encouraged by this heightened audit activity and believe it should continue.

With respect to access to information, the Revenue Reconciliation Act of 1989 included, with our support, important amendments to the reporting and recordkeeping requirements applicable to transactions between foreign-owned corporations and their overseas affiliates.

In addition, the 1989 act provides significant new earnings stripping rules which limit the ability of domestic tax-exempt and foreign owners to reduce the taxable income of their U.S. subsidiaries through payments of interest where such cash flows are more properly characterized under arm's-length principles as nondeductible returns on equity.

We are currently reviewing public comments with respect to the amendments to Internal Revenue Code section 6038A and the new earnings stripping provision.

Regulations to implement these provisions have been given a high priority by both the Treasury Department and the Internal Revenue Service.

Additional legislation has recently been proposed to enhance the compliance rules applicable to foreign-owned companies.

With respect to the proposed change to apply the amendments to section 6038A to all open tax years, we note that similar effective date provisions have been used for other amendments to procedural rules in the past.

Further, the proposed change to apply similar rules to foreign-owned U.S. branches is designed to conform the rules for foreign branches and foreign subsidiaries.

The administration does not oppose these two suggested changes to the current tax compliance rules.

However, we do oppose new proposals which would discriminate against foreign-owned businesses in violation of our treaty obligations.

For example, one proposal in H.R. 4308 would extend the statute of limitations where taxpayer delay has impeded a timely assessment of tax, but only for foreign-owned companies.

If such a change to the statute of limitations makes sense, it should apply for both domestic and foreign-owned companies.

We must note, however that competent authority proceedings to adjust double taxation questions between the IRS and foreign revenue authorities are already hampered in some cases by expired statutes of limitations in the foreign jurisdiction, and that a lengthened U.S. statute may exacerbate this problem.

In sum, we believe that the ongoing efforts at the audit level and the new compliance measures enacted in 1989 should produce positive results in terms of tax compliance.

We would urge that these new developments be given adequate time to work before introduction of major new initiatives.

In addition, we must keep in mind that cross-border transactions, by definition, affect the taxing authority and interest of at least one other country.

Our actions in this area—which affect both U.S. investment abroad and foreign investment in the United States—must withstand the test of fairness and must adhere to international standards if the United States is to continue to enjoy the benefits of cooperative relationships with the fiscal authorities of other countries.

These relationships, over time, should contribute more to the collection of tax than overly harsh unilateral action.

Let me now, since it is not in my statement, speak to Mr. Anthony's point.

I have spoken briefly with Commissioner Goldberg about the $10 million item.

I would refer the committee to the Commissioner who is responsible for these kinds of budgetary matters.

I can say in brief that to the extent that the appropriation action is simply an earmarking, it really is not helpful to the extent that it might be additional resources, the Commissioner would probably be quite interested.

Mr. ANTHONY. Mr. Chairman, would you yield?

Chairman PICKLE. I am going to ask again—we have accepted your summarized statement.

This is a very serious issue and it has been difficult for me and I imagine for most members to keep up with your general statement.

We are going to have to take your written statement. I want to insist again next time that we have a better agreement about how you proceed.

[The statement of Mr. Gideon follows:]

EMBARGOED FOR RELEASE UNTIL DELIVERY
EXPECTED AT 11 A.M., EDT

STATEMENT OF KENNETH W. GIDEON,
ASSISTANT SECRETARY (TAX POLICY),
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
JULY 12, 1990

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss tax compliance issues presented by the operation of foreign-owned businesses in the United States. We understand that this Subcommittee is particularly interested in whether U.S. subsidiaries of foreign companies are paying their fair share of U.S. tax. This is part of the broader issue of related-company transfer pricing problems that may arise for both inbound and outbound transactions.

I. OVERVIEW OF THE ISSUE

The focus of this hearing is generally on compliance issues presented by Internal Revenue Code ("Code") section 482. This inquiry involves a review of the Internal Revenue Service's ability to obtain adequate information relevant to intercompany transfers of goods and services and to conduct effective audits of such transactions.

As you know, Code section 482 gives the Internal Revenue Service the authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities in order to prevent evasion of taxes or clearly to reflect their income. This authority is necessary to prevent taxpayers from structuring transactions in a manner which artificially shifts items of income or deductions to those affiliates that can benefit most from such items. In particular, section 482 is necessary to block the artificial transfer of taxable income to foreign affiliates outside of the U.S. tax jurisdiction.

As Commissioner Goldberg has testified in detail, there are a number of possible scenarios for such artificial transfers of income. Examples include manipulation of the transfer prices at which goods are sold between related parties, provision of services which would not be offered between unrelated parties in comparable transactions, and payment of excessive deductible payments. Current regulations under section 482 test such transactions by applying the internationally accepted "arm's length" standard. Thus the regulations authorize an adjustment of intercompany transactions to the extent they differ from the results which would have been negotiated by unrelated parties. Such adjustments are generally made by reference to comparable transactions between unrelated parties. Where comparable transactions are not available, the regulations use other methods to approximate arm's length results.

In the Tax Reform Act of 1986, Congress amended section 482 to address particular difficulties presented by the transfers of intangible property.[1] This change in the statute applies to all transfers of intangibles. In the legislative history describing the change, however, Congress indicated its particular concern with cases involving transfers of highly profitable intangibles to offshore affiliates where the payments returned to the U.S. were insufficient in comparison to the income earned from the intangible by the foreign transferee. In addition, Congress suggested that a comprehensive study of intercompany pricing rules should be conducted and that consideration should be given to possible modification of the regulations under section 482.

In October of 1988, the Treasury and the Internal Revenue Service published a joint discussion draft of this issue, "A Study of Intercompany Pricing" (the "White Paper"). That study emphasized the need to maintain the current "arm's length" standard under the section 482 regulations, but proposed new methods for applying that standard in cases of transfers of intangible property. We have received voluminous comments from taxpayers, academics, and foreign governments in response to the White Paper and we are participating in ongoing dialogues with interested parties to develop acceptable approaches. The Treasury Department is also working closely with the Internal Revenue Service in developing proposed regulations to implement certain of the suggestions made in the White Paper.

The focus of this Subcommittee today, whether foreign-owned U.S. subsidiaries are paying their fair share of tax, is of course the reverse of the problem presented by outbound transfers of intangibles which Congress addressed in 1986. Yet this contrast illustrates an important principle -- any changes to our methods for determining the "fair" distribution of income among affiliated entities must be balanced and reasonable. Over-extension of our rules to prevent perceived abuses in cases of outbound transfers by U.S. companies would seriously jeopardize our tax collections from the inbound investments of foreign companies. For example, if new methods for determining transfer prices in the section 482 regulations overcompensate U.S. parent companies for transfers of property to their offshore subsidiaries, these methods when applied to foreign parents of U.S. subsidiaries would exacerbate the very problem which this Subcommittee is examining today. Indeed, given the magnitude of United States investment abroad, all of us concerned with transfer pricing questions must keep in mind that United States actions with respect to cross-border transactions must be viewed as being fair and in accordance with international norms. Otherwise, foreign governments can be expected to respond to protect their interests against unilateral United States actions which those governments deem inappropriate.

It is important to recognize, therefore, that there are no quick statutory or regulatory solutions which would make section 482 cases easy to resolve. It is also important to remember that transfer pricing is an issue with respect to outbound as well as inbound investment. Nevertheless we believe that important developments at the audit level and new compliance rules which were introduced last year will make substantial positive improvements in the IRS's ability to process transfer pricing cases in the context of foreign-owned companies. Before discussing those initiatives, I will review some of the available statistics relating to the performance of these companies and consider their implications in the area of tax compliance.

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[1] Section 482 was amended by adding the sentence, "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

II. STATISTICAL REVIEW OF COMPLIANCE BY FOREIGN-OWNED COMPANIES

Total foreign direct investment in the U.S. has increased rapidly over the last decade, whether measured by the equity and debt provided by foreign direct investors to their U.S. affiliates (the balance of payments measure of foreign direct investment) or by the total assets owned by these affiliates. More specifically, the assets of foreign-owned U.S. corporations have grown from $205 billion in 1979 to $959 billion in 1987, or about 6 percent of the total assets of all U.S. corporations.[2] Concern has been expressed over the fact that despite the corresponding growth in the revenues received by these companies -- from $242 billion in 1979 to about $687 billion in 1987 (or about 7 percent of the total receipts of all U.S. corporations)-- their income as reported for tax purposes has not shown similar growth. Indeed, over the 1979-1987 period, their net income (as measured by the excess of their total revenues over total deductions, increased by certain items of constructive taxable income and reduced by tax-exempt income) has fluctuated from a high of $6 billion in 1979 to a low of -$1.5 billion in 1986.

In this section, statistics based on the 1987 tax return data as compiled by the Statistics of Income Division (SOI) of the Internal Revenue Service are used to examine the extent to which aggressive transfer pricing and other tax accounting practices may have been used by these firms to reduce their corporate tax payments. While the SOI data can be particularly helpful in suggesting magnitudes, the limitations of using the data for this purpose should be recognized. The extent to which any specific company may have engaged in such practices can only be determined from a detailed audit examination of the tax and other accounting records of the company, including a detailed review of its transactions with related parties.

A comparison of the return earned by multinational corporations with the returns earned by their related suppliers might provide the most direct indication of the presence of potential transfer pricing problems. Although the SOI data allow such comparison for U.S. multinationals, the required information is not available for foreign multinationals. The statistics for foreign-controlled U.S. corporations are instead compared to the corresponding statistics for U.S.-controlled firms. To the extent aggressive transfer pricing practices are used by U.S.-controlled corporations, such comparative analysis may be less helpful in gauging the extent to which such practices are also used by foreign-controlled firms.

A. Low Overall Profitability

As noted, one of the most striking aspects of the rapid increase in direct foreign investment is the rather low net income reported by foreign-controlled U.S. corporations. Exhibit 1 presents information on the gains and losses of foreign and U.S. controlled corporations (as measured by total receipts less total deductions). It also presents information on the assets of these companies and on the tax accounting rate of return (as measured by the ratio of the gains or losses to the assets) for each of the industries in which this Subcommittee has expressed an interest. The statistics presented in Exhibit 1 generally indicate that the low overall profitability does not reflect uniformly poor performance by all foreign-controlled U.S. corporations. Rather, some foreign-controlled U.S. corporations are as profitable as many U.S.-owned firms. However the proportion of firms that incur losses is higher for foreign-controlled firms. Exhibit 1 also shows that this overall tendency is present in most (but not all) separate industries. Except for motor vehicles (retail) and sporting goods (wholesale), foreign-controlled U.S. corporations have, on average, lower rates of return on assets than their U.S.-controlled counterparts.

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[2] The nearly $960 billion 1987 level of assets of these foreign-controlled U.S. corporations was financed by about $235 billion in equity and loans from their foreign parent corporations, with the balance provided by minority equity owners (about $50 billion) and unrelated creditors (about $675 billion). The $235 billion balance of payment measure, together with another $35 billion in equity and debt invested by foreign parent corporations in unincorporated U.S. affiliates, accounts for the total $271 billion in foreign direct investment reported for 1987. This balance of payments measure of foreign direct investment has grown to $329 billion in 1988 and to $401 billion in 1989.

It might be tempting to infer from these data that foreign-controlled U.S. firms are practicing aggressive transfer pricing. Why, otherwise, would they accept such apparently unattractive rates of return on their invested capital? However, the interpretation of data such as that included in Exhibit 1 must be done with extreme caution. While aggressive transfer pricing may be one explanation, other factors such as start-up expenses, acquisition indebtedness, the age of the investment, the experience and skills of the management, the specific type of product being produced, and the nature of the manufacturing process also affect the observed returns. In short, careful analysis of more detailed firm-specific data is needed to understand the precise significance of the industry aggregates presented in Exhibit 1. This caveat also applies to all of the other data presented in this section.

B. Lower Gross Profit Ratios

In Exhibit 2, the ratios of gross profit (i.e., gross receipts less cost of sales and operations) to gross receipts (or sales) are noted. If foreign-controlled corporations pay their related foreign suppliers more for the goods acquired than would be paid in an "arm's length" transaction, this would be consistent with a lower gross profit ratio. Exhibit 2 shows that the gross profit ratios for foreign-controlled corporations are indeed much lower than those for U.S.-controlled corporations. On average, the gross profit ratio for foreign-controlled corporations is about 69 percent that for U.S.-controlled corporations, and for firms engaged in the motor vehicle wholesale trade (SOI industry code 5010) it is half that for U.S.-controlled firms.

C. Comparable Interest And Depreciation Expense Ratios

To explore whether foreign-controlled corporations might engage in greater "earnings stripping" (i.e., the reduction in taxable income through the use of leverage, especially that provided by related creditors), the ratio of their interest expense to their net income before interest (total receipts plus interest paid less total deductions) and to their assets are noted in Exhibit 3. Because the interest expense used in these calculations is that paid to all creditors, and not just that paid to related creditors, these ratios suggest, but do not confirm, utilization of "earnings stripping". The results are ambiguous. When measured with respect to the income before interest expense, the statistics indicate that on average foreign-controlled corporations operate with somewhat greater leverage than U.S.-controlled corporations. For firms in some industries, particularly consumer electronics and electronic components manufacturing (SOI industry codes 3665 and 3670, respectively), this difference is particularly noticeable.

However, when measured against the assets employed, with certain exceptions the foreign-controlled corporations appear to use less leverage. By this measure, which may be more reflective of the financial structure of the firms, the degree of leverage used by foreign-controlled firms engaged in consumer electronics manufacturing (SOI industry code 3665) does not appear to be very different from that used by U.S.-controlled firms, although foreign-controlled firms in the motor vehicle wholesale trade do appear to use a greater degree of leverage than their U.S.-controlled counterparts.

The potentially higher depreciation expenses associated with the start-up of their U.S. operations has been suggested as a possible reason for the lower profitability of foreign-controlled U.S. corporations. These higher charges are assumed to arise either from the more recent acquisition of their depreciable assets or the step-up in basis allowed in certain take-overs. To investigate this possibility, the ratios of the reported depreciation expense to total assets of the U.S.- and foreign-controlled corporations are also noted in Exhibit 3. As may be seen, with the possible exception of firms engaged in motor vehicle manufacturing (SOI industry code 3710), the foreign-controlled corporations do not appear to have appreciably higher depreciation expenses per dollar of assets.

D. Lower Taxes Paid Per Dollar of Receipts

Exhibit 4 provides information on the total receipts, the tax liabilities (after credits), and the ratios of the tax liabilities to total receipts reported by foreign-and U.S.-controlled corporations. On average, foreign-controlled corporations paid less taxes per dollar of receipts than did U.S.-controlled corporations. However, profitable foreign-controlled corporations paid about $4.6 billion in taxes in 1987. Moreover, in two industries -- the motor vehicle wholesale and retail trades (SOI industry codes 5010 and 5515, respectively) -- foreign-controlled corporations paid more per dollar of total receipts than did U.S.-controlled corporations.

E. Conclusion

While aggressive transfer pricing practices may be one explanation for the data presented in Exhibits 1-4, the evidence is not conclusive because firm-specific factors other than transfer pricing may account for the results noted. Nevertheless, on the basis of these aggregate figures, it would seem appropriate to scrutinize carefully the transfer pricing practices of foreign-controlled U.S. firms.

III. INITIATIVES TO ADDRESS THE PROBLEM

Each comparison of related party transactions to the "arm's length" norm requires a thorough analysis of all the relevant facts and circumstances. Two factors are essential in order to process these cases in a manner which is fair to both the government and the taxpayer: a significant commitment of personnel and broad access to the relevant data. We believe that major progress has been made in recent years with respect to both of these factors in the context of foreign-owned corporations operating within the United States.

A. Increased Audit Activity

As Commissioner Goldberg explained, the Internal Revenue Service has for several years been increasing its review of foreign-owned companies, with particular emphasis on the transfer pricing practices between U.S. companies and their foreign affiliates. We are encouraged by the heightened audit activity which has resulted from these efforts and expect that such scrutiny will encourage compliance with international transfer-pricing standards.

The Internal Revenue Service's continued expansion of its Industry Specialization Program should also have a positive impact on audits in the international area. That program has successfully created groups of attorneys and agents to serve as focal points within the Service where issues involving specific industries or transaction types can be developed and analyzed. Attorneys from Chief Counsel (International) and international examiners participate in any of these groups when international tax issues arise.

One factor which makes the audit of cross-border transactions difficult is the need for cooperation among the tax administrators of the different governments. For example, a parent company that manufactures products in a high tax jurisdiction for distribution and sale by its United States subsidiary might route its transactions through a corporation in a low-tax jurisdiction. In this case, both the country of manufacture and the United States have an interest in preventing the shifting of profits into the low-tax country affiliate. For this reason, the Internal Revenue Service is actively pursuing simultaneous examinations where both countries cooperate in the audit of a single group of related taxpayers. Such intergovernmental cooperation should be encouraged and expanded to reach more taxpayers and involve more countries.

B. Legislative Changes to Tax Compliance Rules

Recent legislation has made substantial changes to the rules affecting tax compliance of foreign-owned companies. With respect to access to information, the Revenue Reconciliation Act of 1989 ("the 1989 Act") included, with our support, important amendments to the reporting and record-keeping requirements applicable to transactions between foreign-owned corporations and their overseas affiliates.

One of the principal problems in reviewing transactions between U.S. subsidiaries and their foreign affiliates is providing the international examiners with access to all relevant data. Adequate information with respect to such transactions is required at each stage of the process: information reporting with the tax return facilitates audit screening; record maintenance requirements ensure that documents related to intercompany transactions are retained for review; and effective summons authority makes such documents available where the taxpayer fails to comply with initial requests.

In many cases involving related party transactions of foreign-owned U.S. corporations, adequate information has been difficult to obtain. Proper allocation of income among such related companies often requires the review of documents which are in the sole custody of the foreign owner. Moreover, the extent to which courts will uphold the IRS's summons power over foreign-based documents depends on the particular facts presented and can be unclear under current case law, at least prior to recent legislation.[3] Even where a summons is legally enforceable, records may not be available due to the foreign owner's having not maintained relevant documents.

Information reporting for audit screening purposes has also been insufficient in certain cases. Under pre-1989 law, Code section 6038A required reporting of information with respect to related party transactions only in the case of U.S. subsidiaries (or foreign corporations engaged in a U.S. business) that were controlled by a foreign person. For this purpose, "control" was defined as at least 50 percent stock ownership by a single foreign person. This ownership test, however, omitted cases where actual control was exercised by substantial foreign owners but 50 percent of the stock was not held by a single foreign person.

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[3] United States v. Toyota Motor Corp., 561 F. Supp. 354 (C.D. Cal.), 569 F. Supp. 1158 (C.D. Cal. 1983).

Congress determined last year that these compliance and record-keeping provisions were inadequate to provide the information needed in this area. As a result, the 1989 Act substantially amended Code section 6038A to strengthen the record-keeping and compliance provisions applicable to foreign-owned entities.

Under the 1989 Act, the threshold for application of Code section 6038A is reduced to 25 percent stock ownership by a single foreign person. In addition, foreign-owned corporations are now required to maintain such records prescribed in regulations which are appropriate to determine the correct tax treatment of related party transactions. To ensure access to relevant documents, foreign affiliates are required to designate the U.S. taxpayer as their limited agent solely for purposes of service of any IRS summons relating to intercompany transaction records.

The 1989 Act also increases the monetary penalties for noncompliance with information reporting and record maintenance requirements. In addition, where a summons is not substantially complied with (or the related party fails to authorize its U.S. agent to receive a summons) the 1989 Act gives the Secretary of the Treasury the discretion to determine the deductions allowed and costs of any property attributable to transactions with that foreign related party.

Several significant procedural protections are incorporated into these new provisions. Taxpayers are granted expedited access to federal court to quash a summons and to challenge the government's determination that they have not substantially complied with a summons. The appointment of the U.S. corporation as an agent will not subject documents or witnesses to legal process for any purpose other than determining the correct tax treatment of intercompany transactions. Moreover, where information exchange provisions under our bilateral tax treaties are adequate to protect the government's interest, the legislative history notes that the IRS will be expected to use the treaty procedure before the expanded summons power.

We believe that these provisions, as finally enacted, reflect the United States' legitimate interests in monitoring and adjusting the tax effects of intercompany transactions between U.S. corporations and their foreign owners. Foreign subsidiaries of U.S. corporations are required to supply similar information and are subject to comparable penalties for noncompliance. We intend to implement these recent statutory changes so that the overall effect of these compliance measures is to treat foreign-owned U.S. companies in a manner which is comparable to the treatment of U.S.-owned companies, recognizing that some differences in method may be necessary where information pertinent to a U.S. tax examination is controlled by a non-U.S. person.

In addition, the 1989 Act provides significant new "earnings stripping" rules which limit the ability of domestic tax-exempt and foreign owners to reduce the taxable income of their U.S. subsidiaries through payments of "interest" where such cash flows are more properly characterized under arm's length principles as nondeductible returns on equity. We believe that such measures to enforce reasonable thin capitalization principles are consistent with international norms and the United States' obligations under its bilateral tax treaties.

We are currently reviewing public comments with respect to the amendments to section 6038A and the new "earnings stripping" provision. Regulations to implement these provisions have been given a high priority by both the Treasury Department and the Internal Revenue Service.

C. New Compliance Proposals

Additional legislation has recently been proposed to enhance the compliance rules applicable to foreign-owned companies. H.R. 4308 and S. 2410. With respect to the proposed change to apply the amendments to section 6038A to all open tax years, we note that similar effective date provisions have been used for other amendments to procedural requirements. Further, the proposed change to apply similar rules to foreign-owned U.S. branches is designed to conform the rules for foreign branches and foreign subsidiaries. The Administration does not oppose these two suggested changes to the current tax compliance rules. We stand ready to work with the Congress on these proposals to assure that they apply fairly and that taxpayers can reasonably comply. It is important that the burden on U.S.. branches not be materially different from that on U.S. subsdidiaries of foreign corporations. Also, the focus should be on maintaining information, rather than increasing the reporting burden.

For each new change to our compliance rules, however, our obligations under bilateral treaties and the basic requirements of fair play require that we maintain comparable treatment between foreign-owned entities and U.S.-owned entities. In addition, the U.S. should not be advocating new rules to be imposed on foreign multinationals which we would find objectionable if applied to our own companies by another government. We recognize of course that the difficulties encountered in audits of foreign-owned entities prohibit absolute identity of our procedural rules. Nevertheless, the overall record-keeping and compliance requirements applicable to foreign-owned companies must remain comparable with the standards we impose in the context of U.S.-owned companies.

For this reason, we oppose new proposals which would impose additional requirements in a discriminatory manner in violation of our treaty obligations.[4] For example, one proposal in H.R. 4308 would extend the statute of limitations where taxpayer delay has impeded a timely assessment of tax, but only in the case of foreign-owned companies. If such a change to the statute of limitations makes sense, it should be applied for both domestic and foreign-owned companies. We must note, however, that competent authority proceedings to adjust double taxation questions between the IRS and foreign revenue authorities are already hampered in some cases by expired statutes of limitations in the foreign jurisdiction, and a longer U.S. statute may exacerbate this problem. On the other hand, before the enactment of section 6038A last year, taxpayers appeared to be increasingly unwilling to extend the statute voluntarily in circumstances where, because of less than full cooperation in document production, such an extension would be appropriate. Given the procedural complications which could arise from a change in the statute of limitations, Congress could appropriately defer action on the proposed extension to allow time to assess the impact of last year's changes in section 6038A. This seems particularly appropriate if those changes are made applicable to open years.

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[4] We also oppose the proposal in the same pending bills to tax capital gains of certain foreign shareholders; however, this is a substantive change in law which we view as beyond the scope of this hearing.

In sum, we believe that the ongoing efforts at the audit level and the new compliance measures enacted in 1989 should produce positive results in terms of tax compliance. We would urge that these new developments be given adequate time to work before introduction of major new initiatives. In addition, we must keep in mind that cross-border transactions, by definition, affect the taxing authority and interests of at least one other country. Our actions in this area -- which affect both U.S. investment abroad and foreign investment in the U.S. -- must withstand the test of fairness and must adhere to international standards if U.S. businesses are to continue to enjoy the benefits of cooperative relationships between the fiscal authorities of other countries.

Exhibit 1

1987 Income, Assets, and Rates of Return for Foreign- and U.S.-Controlled U.S. Corporations, by Industry and Profitability

Industry	Foreign-Controlled			U.S.- Controlled[1]		
	Gain Cos.	Loss Cos.	Total	Gain Cos.	Loss. Cos.	Total
I. Income (in $ millions):[2]						
Motor vehicles (manufac.)	47	(428)	(381)	6,466	(2,005)	4,461
Motor vehicles (wholesale)	1,475	(973)	502	933	(262)	671
Motor vehicles (retail)	46	(5)	41	1,457	(733)	724
Household appliances (manufac.)	69	(6)	63	626	(63)	563
Consumer electronics (manufac.)	380	(181)	200	1,134	(407)	726
Electronic component (manufac.)	202	(337)	(135)	4,197	(1,595)	2,601
Sporting goods (wholesale)	110	(119)	(9)	289	(376)	(87)
Electrical goods (wholesale)	472	(399)	72	1,242	(385)	857
All other	16,586	(11,504)	5,083	349,511	(91,403)	258,108
Total	19,388	(13,952)	5,436	365,855	(97,229)	268,626
II. Assets (in $ millions):						
Motor vehicles (manufac.)	2,023	4,720	6,743	196,832	174,925	371,756
Motor vehicles (wholesale)	14,646	13,156	27,802	12,855	3,470	16,325
Motor vehicles (retail)	1,004	100	1,104	31,930	15,855	47,785
Household appliances (manufac.)	1,863	125	1,989	7,133	2,611	9,744
Consumer electronics (manufac.)	6,790	2,901	9,691	14,255	3,884	18,139
Electronic component (manufac.)	2,979	2,258	5,237	55,835	16,101	71,936
Sporting goods (wholesale)	2,483	843	3,326	2,903	1,277	4,179
Electrical goods (wholesale)	10,025	3,877	13,903	16,040	3,146	19,186
All other	508,850	380,750	889,600	9,551,812	2,723,970	12,275,782
Total	550,664	408,730	959,394	9,889,594	2,945,239	12,834,833

Exhibit 1 (continued)

1987 Income, Assets, and Rates of Return for Foreign- and U.S.-Controlled U.S. Corporations, by Industry and Profitability

Industry	Foreign-Controlled			U.S.-Controlled[1]		
	Gain Cos.	Loss Cos.	Total	Gain Cos.	Loss. Cos.	Total
III. Rate of Return (in percent):						
Motor vehicles (manufac.)	2.35	(9.07)	(5.65)	3.29	(1.15)	1.20
Motor vehicles (wholesale)	10.07	(7.40)	1.80	7.26	(7.54)	4.11
Motor vehicles (retail)	4.62	(5.04)	3.74	4.56	(4.62)	1.51
Household appliancess (manufac.)	3.70	(4.67)	3.18	8.78	(2.41)	5.78
Consumer electronics (manufac.)	5.60	(6.23)	2.06	7.95	(10.49)	4.00
Electronic components (manufac.)	6.77	(14.91)	(2.58)	7.52	(9.91)	3.62
Sporting goods (wholesale)	4.44	(14.12)	(0.26)	9.97	(29.46)	(2.08)
Electrical goods (wholesale)	4.70	(10.30)	0.52	7.74	(12.23)	4.47
All other	3.26	(3.02)	0.57	3.66	(3.36)	2.10
Total	3.52	(3.41)	0.57	3.70	(3.30)	2.09

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[1] Only data for U.S.-controlled corporations filing a form 1120, 1120A, 1120L, and 1120PC (for industry code 6359) are included in these Exhibits. Data for corporations filing a Form 1120S, 1120F, 1120-IC-DISC, 1120-FSC, 1120-RIC, 1120-REIT, and 1120PC (for industry code 6356) are excluded.

[2] Income is measured by total receipts less total deductions.

Exhibit 2

1987 Gross Profit Ratios for Foreign- and U.S.-Controlled U.S. Corporations, by Industry (in percent)[1]

Industry	Foreign-Controlled	U.S.-Controlled
Motor vehicles (manufac.)	15.78	19.98
Motor vehicles (wholesale)	11.06	22.10
Motor vehicles (retail)	13.95	12.85
Household appliances (manufac.)	25.54	29.61
Consumer electronics (manufac.)	40.50	36.51
Electronic component (manufac.)	21.90	34.26
Sporting goods (wholesale)	24.05	25.61
Electrical goods (wholesale)	19.82	25.00
All other	25.68	36.38
Total	23.88	34.76

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[1] Ratio of gross profit (gross receipts less cost of goods and operations) to sales (gross receipts).

Exhibit 3

1987 Ratios of Interest Expense to Earnings Before Interest and Assets and Depreciation Expense to Assets, for Foreign- and U.S.-Controlled U.S. Corporations, by Industry (in percent)

Industry	Interest to Earnings[1]		Interest to Assets		Depreciation to Assets	
	Foreign-Controlled	U.S.-Controlled	Foreign-Controlled	U.S.-Controlled	Foreign-Controlled	U.S.-Controlled
Motor vehicles (manufac.)	82.06	69.97	3.27	4.37	5.78	4.62
Motor vehicles (wholesale)	46.44	36.28	4.58	3.21	4.54	4.11
Motor vehicles (retail)	48.48	58.33	3.92	4.25	3.92	4.66
Household appliances (manufac.)	36.53	32.49	2.05	3.07	4.38	3.72
Consumer electronics (manufac.)	38.21	24.58	2.38	2.10	4.63	5.80
Electronic component (manufac.)	51.93	25.94	4.19	2.18	4.47	4.83
Sporting goods (wholesale)	48.28	35.47	3.09	3.79	1.76	2.94
Electrical goods (wholesale)	46.42	34.75	2.98	3.44	2.00	2.83
All other	67.49	60.42	3.71	3.80	1.89	1.97
Total	65.54	60.21	3.71	3.81	2.04	2.08

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[1] Earnings before interest measured by total receipts plus interest paid less total deductions.

Exhibit 4

1987 Tax After Credit, Total Receipts, and Ratios of Tax After Credit to Total Receipts for Foreign- and U.S.-Controlled U.S. Corporations, by Industry

Industry	Tax After Credits		Total Receipts		Tax A.C. to Receipts	
	Foreign-Controlled	U.S.-Controlled	Foreign-Controlled	U.S.-Controlled	Foreign-Controlled	U.S.-Controlled
	(in $ millions)				(percent)	
Motor vehicles (manufac.)	10	1,961	6,325	351,073	0.16	0.56
Motor vehicles (wholesale)	586	295	68,328	41,196	0.86	0.72
Motor vehicles (retail)	12	371	3,070	181,739	0.38	0.20
Household appliances (manufac.)	14	217	3,452	10,714	0.41	2.03
Consumer electronics (manufac.)	72	250	8,542	22,924	0.84	1.09
Electronic component (manufac.)	63	973	8,898	83,119	0.71	1.17
Sporting goods (wholesale)	33	82	6,684	8,802	0.50	0.94
Electrical goods (wholesale)	135	389	24,925	43,065	0.54	0.90
All other	3,636	75,319	556,560	6,930,335	0.65	1.09
Total	4,561	79,856	686,786	7,672,966	0.66	1.04

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Chairman **Pickle**. Mr. Anthony.

Mr. **Anthony**. I wanted to get a clarification from Mr. Gideon on the earmarking comment.

I took it that you said that earmarking of the $10 million specifically for audits of section 482 would be a dangerous precedent and would not—you would not favor it?

Mr. **Gideon**. We would not favor—the problem with earmarking is that it creates an inflexibility in the Service's budget so that you are restricted to specific kinds of activities when in point of fact good resource and administration of the Revenue Service may require more flexibility at any given time.

But on the other hand, I think that it is clear that resources devoted to this area have been rising. While I think that the Service would be troubled by restrictions that limits flexibility in administering its budget, on the other hand, it is probably quite interested in this if it, in fact, involves new resources.

Mr. **Anthony**. If my information is correct, the Appropriations Committee gave an additional $600 million in general budget moneys to the IRS and that this $10 million was an add-on to that.

So in that case, it would seem to me that the earmarking is a specific acknowledgement that there may be in your language, that there may be tax avoidance and that additional resources would give us a greater opportunity to ferret out.

Do you use any kind of rule of thumb on moneys that are spent by the Service in terms of moneys return, what is the cost benefit ratio? Do you have a rough rule of thumb?

Mr. **Gideon**. We have been chary of rough rules of thumb because they can all be criticized. I think it is fair to say that we think dollars invested in resources produce more than a dollar of return to the Government and usually a multiple.

Mr. **Anthony**. I believe Customs has testified, or I have information, that their rule of thumb is 7 to 1.

Would it be that high in the IRS or in Treasury?

Mr. **Gideon**. I wouldn't be able to give you a specific figure, Mr. Anthony.

Mr. **Anthony**. Other than to say that a dollar invested is certainly going to be returned in value if the examinations prove fruitful?

Mr. **Gideon**. I think that is probably correct.

Mr. **Anthony**. I yield my time.

Chairman **Pickle**. Mr. Secretary, first let's see if we understand each other.

You said in your statement that transfer pricing practices and the tax avoidance by multinational corporations is a serious problem and that we must add additional or greater emphasis to its solution; is that correct?

Mr. **Gideon**. There is certainly data there to indicate that we ought to be looking carefully at the transfer pricing practices of these firms.

Chairman **Pickle**. Then you don't classify this as a serious problem. You said we should be careful.

Mr. **Gideon**. I think that it certainly bears serious attention.

I was not trying to say it was not a serious issue. It is a serious issue.

Chairman **Pickle**. Can you tell me then what would be your estimate of the amount of revenue we are losing from abusive transfer pricing?

Mr. **Gideon**. We really do not have a way of estimating that number for you, Mr. Pickle, other than to say——

Chairman **Pickle**. Can you give us a ballpark figure? Would it be $50 million or $100 billion——

Mr. **Gideon**. I would find $50 billion very hard to accept given the fact that overall corporate tax collections in the United States are a little more than twice that.

Having said that, I think that the possibility that there is a large number there is one that certainly bears investigation.

Chairman **Pickle**. We asked the Internal Revenue Commissioner yesterday, and he said it was a serious problem. It is a major amount, but he wouldn't give us a figure.

I am asking you that and you say it is a serious problem, but you couldn't give us a ballpark figure.

Now, the media, who deal in the realm of financial transactions and taxes estimated earlier this year in several instances that tax avoidance might be as much as $12 billion.

That is their estimate.

Our committee, in talking to the IRS—the people that we had before us Tuesday—they gave us a figure that says that it ought to be somewhere in the neighborhood of $30 billion.

Let me tell you roughly how we arrive at this number and you may just comment on it.

The IRS Commissioner on Tuesday told us that U.S. multinationals operating overseas earn between 8 and 10 percent in profits before taxes.

That was their statement.

For example, U.S. companies operating in Japan in 1986 reported gross receipts of $28 billion and profits of $3 billion or approximately 10 percent.

These are figures from the Commissioner and the field people.

So let's assume that foreign-owned companies operating in the United States will generate approximately $1 trillion in gross receipts in 1990.

That is a guess, but we know they had $600 to $700 billion 3 years ago. Ten percent of $1 trillion is $100 billion.

If this $100 billion is taxed in the United States at the 34 percent rate, that would equal $34 billion.

We know the effective rate is less, of course. We also know that these companies have never paid more than $5 billion in U.S. taxes in any one year. Therefore, we estimate that it might be as much as $30 billion.

If you have any information to refute that or challenge that or can give us a better figure, we would like to have it.

We are trying to get a handle so the people of the United States can know roughly what this figure is.

I want to ask you specific questions now regarding your testimony, some of which you skipped over in your effort to condense it, but I think we have the essence of what you are recommending.

We are trying to decide what can we do.

So, first, could I say that you are of general agreement if we could advance some acceptable and workable legislation that we ought to attempt to do it in the committee?

Mr. GIDEON. That is correct, with respect to the two items we identified.

Chairman PICKLE. My first question is, would you continue to support the legislation that we enacted last year under section 6038 to give the IRS better access to records?

Mr. GIDEON. As my statement indicates, we certainly wouldn't oppose that.

Chairman PICKLE. Do you support expansion of the rules to open years; that is, where the statute of limitations has not run?

Mr. GIDEON. Same position on that one.

Chairman PICKLE. Does the bill adequately address issues involving branches of foreign subsidiaries; banks, in other words?

Mr. GIDEON. That is the 6038C proposal that you have alluded to.

In other words, what would happen under that provision is that it would be—the 6038A rules enacted last year would be extended in the form of a 6038C statute.

Chairman PICKLE. You would support extending it to branches?

Mr. GIDEON. Yes.

Chairman PICKLE. The chairman of our committee and some of us who joined in this legislation have introduced it to try to make improvements in this field and that would be agreeable to you?

Mr. GIDEON. Yes.

Chairman PICKLE. Do you support extending the statute of limitations for 3 years where there has been delay or other unacceptable actions by the taxpayer?

Mr. GIDEON. No, at least in the current form because in the current form it is discriminatory in the sense that it applies only to foreign-owned firms.

Chairman PICKLE. Suppose we extend it to both foreign multinationals and the U.S. corporations—both ways?

Mr. GIDEON. I think it still is questionable, but on the other hand, you certainly removed our major objection if you do it both ways.

Chairman PICKLE. That is it wouldn't be discriminatory?

Mr. GIDEON. It would not be discriminatory if it applied both ways.

Chairman PICKLE. We would like to work with you on that issue. I notice you said you would not support provisions dealing with the taxation of capital gains?

Mr. GIDEON. That is correct.

Chairman PICKLE. I assume that is because it is not specifically related to this subject. Is that the primary reason?

Mr. GIDEON. Yes.

We thought that given the subject of this hearing that we wouldn't go into detail on that, but we simply wanted for purposes of completeness to note our position.

Chairman PICKLE. Are penalties needed to ensure compliance?

Mr. GIDEON. I don't think additional penalties are appropriate at this time.

Remember, this subcommittee did a substantial revision of the penalty structure last year and the general thrust of that was that adding all kinds of ad hoc penalties really didn't work very well.

On the other hand, there may well be cases where the facts suggest that application of the general penalties we have now may be appropriate.

Chairman **Pickle**. Can you tell me why we have had no penalties assessed?

Mr. **Gideon**. In the transfer pricing area, I think it is really difficult to do that unless you could find a flagrant case.

Usually these cases are quite fact intensive, as a result there are reasonable points of view on the other side and when that happens you typically don't get penalties.

Chairman **Pickle**. Yesterday we asked over and over to the IRS field people and the Commissioner whether they have assessed any penalties and I don't think they can recall having assessed a single penalty.

Mr. Flippo says they may have assessed some penalties, but never collected on any of them.

Let me ask you a couple of quick questions.

Do you support the IRS's proposal to more easily hire experts when you get into tax litigation?

Mr. **Gideon**. That is not directly within my purview, but Commissioner Goldberg's statement was clear and we certainly approve of it at Treasury.

Chairman **Pickle**. Do you support expanding the proposal to include experts needed by IRS——

Mr. **Gideon**. It is the expert issue that I was specifically driving at.

I think that the IRS's problems in hiring experts is a major impediment in this area, and to the extent that procedural reform in terms of sole-source hiring could be done I think that is a good idea.

Chairman **Pickle**. Do you support the administration's pay differential proposal?

Mr. **Gideon**. Absolutely.

Going back to Mr. Anthony's question in this area in particular, getting compensation levels up ,to the point that you can be competitive with the private sector may be more important than getting more bodies.

In other words, this is really an issue where getting the Government in a position to pay and retain—the key thing about pay is retention—appropriate levels of expertise I think is just critical.

Mr. **Anthony**. Would you yield?

Chairman **Pickle**. Yes.

Mr. **Anthony**. Would you not also concur that if we are not going to do the hiring but do contracting out that there would be Federal statutes that need to be amended in order to ease the process of contracting out?

Mr. **Gideon**. You are getting me far afield from my area of expertise, but as they bear on this area we are in accord with the Commissioner's testimony.

Mr. **Anthony**. Which does bear that out?

Mr. **Gideon**. Yes.

Chairman PICKLE. We were surprised yesterday when another committee did put $10 million. I recognize the difficulty of earmarking funds particularly in the unified budget, but I think there is a clear recognition by Congress that the public is very concerned about this and the Congress wants to find some answer to it. I think you will find that may be the pivotal point for increases.

The concern of Congress is so deep that we must find a way to ensure that foreign multinationals are paying their fair share of taxes. That is of concern to the Congress.

Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. Section 482 was enacted over 40 years ago when international trade was far less than it is today. The recent increase in global trade obviously has placed a lot of stress on section 482. Is section 482 able to cope with the demands placed on it by the increased global trade?

Mr. GIDEON. I think that it is important that we recognize that our efforts in terms of applying substantive standards here must accord with international norms and section 482 in our judgment does that. There is no easy way.

In other words, the alternatives that are sometimes suggested to section 482 are dependent on much of the same data gathering. The key to this is getting the data in order to make good determinations and that is the thrust of what was done last year in 6038A and the amendments that are on the table this year.

I think that is the right answer rather than going into the substantive rules.

Mr. MCGRATH. Some of the field examiners who testified 2 days ago in regard to that information gathering question had suggested that an addendum to the corporate return be established in order to show how these companies arrived at their pricing mechanism. As I understood from the questioning of Commissioner Goldberg, this perhaps could be done without any new legislation.

Is that something that you could recommend or support?

Mr. GIDEON. I haven't seen a specific proposal and I am reluctant to comment on something where I don't know specifically what we are getting into.

I know the IRS is looking into this matter and I think it probably bears looking into on their part, and when they have a specific recommendation, I am sure we will consider it.

Mr. MCGRATH. Your remark regarding these kinds of investigations, or this kind of treatment can go both ways. Just for the record, how do other countries assure that their foreign subsidiaries which operate in their country pay a reasonable rate of income tax in their country?

Mr. GIDEON. Well, certainly our major trading partners engage in audits, and investigate transfer pricing standards applying the arm's-length standard that we attempt to apply under 482.

Mr. MCGRATH. One of the people testifying Tuesday said that the arm's-length standard was unclear, that nobody seems to understand what it meant, or how it operated and that it was a judgmental tool to use in these investigations.

Should the arm's-length standard be cleared up or strengthened?

Mr. **Gideon**. I think that any time you are getting into questions such as what is an arm's-length rate of return, yes, you are going to encounter some complexity because that is a difficult economic analysis.

I think the problem when you depart from that standard, though, is that you are probably not getting it right, and at least from our standpoint, we think the real key here is to get the data and let's see if we can't apply the standard that we have. You can't apply this standard or any other standard without the data.

Mr. **McGrath**. We are going to hear later on today, Prof. Jim Wheeler from the University of Michigan. He is going to recommend that a new alternative minimum tax, which is based on an assumed rate of return on assets, be applied to corporations that are engaging in this aggressive transfer pricing scheme.

I wonder what your view on that might be?

Mr. **Gideon**. I haven't seen the specific proposal, but I think that unilateral action away from the arm's-length standard bears with it the real risk that we can expect a similar response with respect to substantial U.S. investment abroad.

Mr. **McGrath**. One of the——

Mr. **Shaw**. Would you yield?

You made reference to that, Mr. Gideon, several times during your testimony and several times during the questions and answers.

On Tuesday, Charles Triplett, the Deputy Associate Chief Counsel of the IRS, testified that the foreign subsidiaries of U.S. companies operating in Europe and the Pacific rim earn pretax profits of 8 to 10 percent of gross receipts, but that the foreign-owned U.S. subsidiaries operating in this country earn less than 1 percent, so I don't know if the discrepancy, that they are paying less than 1 percent and our companies doing business abroad pay 8 to 10 percent is a fair tradeoff.

I don't know whether it is a corporate morality or whether it is the laws of the other countries or whether it is the enforcement of the laws in other countries as compared to ours, but this is no fair tradeoff with the U.S. companies.

Mr. **Gideon**. I am not suggesting that if a transfer pricing problem exists that anything should exonerate it. I am suggesting that if we take a unilateral step away from the arm's-length standard that we can expect other jurisdictions to behave accordingly.

Mr. **McGrath**. Let me ask one further question. Among the testimony that we received Tuesday was seemingly a scheme by some of the foreign companies to report losses and create NOL's for several years, then report profits for a year or so and then apply the NOL to them.

Would you recommend changing the NOL carryback and carryforward rules to stop this kind of gaming of our system?

Mr. **Gideon**. Certainly not on a discriminatory basis. I think if you wanted to examine NOL carryforward/carryback rules generally, that is always an interesting question. It was done fairly recently, though, and I would question that as something that would particularly help in this area.

Mr. **McGrath**. I thank the Secretary.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Gideon, are you familiar with the major agreement that was made between the United States and Japan back in June where each country agreed to try to improve trade relations and lower the trade imbalance between the United States and Japan?

Mr. GIDEON. Not in detail, but I am familiar with specific portions of it.

Mr. ANTHONY. I would like to read a quote from the Washington Post dated June 28, and it has a byline from Tokyo. There is a section that directly impacts on the nature of this hearing and I want to read this and then ask for your reaction.

It says,

> The U.S. Government also promised to declare its support for continued foreign investment in the United States and to seek to ensure that Japanese investors are not singled out by Congress for unfair tax treatment. It also pledged to strongly promote exports especially to Japan and to work to improve American education.

Is there anything in that statement that causes you to believe that section 482 would be used to single out the Japanese?

Mr. GIDEON. No. Our whole goal is not to single out anybody in section 482 but to apply the law evenly to U.S. companies doing business abroad and to foreign companies doing business in the United States.

Mr. ANTHONY. The truth is there would be a lot of countries interested in section 482 over and above the United States because not only could they be avoiding taxes here but in other places.

Mr. GIDEON. We so suggest when we confer with them in international meetings.

Mr. ANTHONY. Later today Professor Granfield will testify and I want to mention part of his testimony. He states that section 482 is simply an inadequate policy tool both from the perspective of enforcement but also from the perspective of action compliance by reasonable taxpayers, and he goes on to recommend that section 482 regulations be modified to provide for more options, a formal safe harbor and elimination of the strict priority of the methods.

We also heard a similar plea for flexibility in the regulations from many of the IRS agents Tuesday.

My question is, do you support such modifications of the regulations?

Mr. GIDEON. Again, without getting into specifics, the Treasury Department and IRS published a white paper in 1988 concerning section 482 regulations. There were extensive comments from many sources in response to that white paper, which was what it was intended to elicit, and regulations responsive to the white paper and those comments are in process right now.

Mr. ANTHONY. The white paper response may go directly to my second question, Mr. Gideon. Professor Granfield recommends the appointment of a blue ribbon commission to review the current rules with the goal of coming up with a new international approach to section 482. I know that that has also been mentioned by other members of this subcommittee and other people who are interested in this overall topic.

Two questions here. Would you support a commission, although Treasury has prepared the white paper, and would you be willing to participate if such a blue ribbon commission is established?

Mr. GIDEON. Well, I think it is an interesting idea. Basically I had not considered it before this morning.

The one thing I am concerned about, though, is I think that people want us to get on with the 482 regulations, and I would hope that a study by a group such as this would not delay us in that effort.

Now we are going to be a while getting them out, so I don't want to suggest that those two goals are necessarily inconsistent. But I wouldn't want to be in a position where we had to wait on what this group had to say before we could proceed.

Mr. ANTHONY. I would agree with that comment, but it appears to me that this is so complex, and it entails such a broad geographical area, and that there are other countries who may be outgunned and who may be being gamed also, that the earmarking of the $10 million, the blue ribbon commission, carrying out your regulations with the legislation we passed last year—it seems like we are just going to have to do all of these things if we are to see any success.

Mr. GIDEON. You touch on a point that is very significant and that is we would want to carefully consider the views of other countries as well because this is an area where two taxing interests at minimum are always at stake, and in order to assure them that we are not trying to do something unilaterally to our advantage and their disadvantage, it is important that the standards that evolve in this area be ones that are internationally accepted as fair.

Mr. ANTHONY. I would agree. You have a low tax country versus somebody that would be a moderate tax, it seems like that country would be as interested in collecting their fair share, albeit it may be lower than our country's. I agree with what you say in terms of international ramifications.

I yield back.

Chairman PICKLE. Mr. Anthony asked a question about Japan, that they want to be certain that they would not be penalized or we would not have roadblocks in the sale of their goods over here.

I hope this hearing does not leave the impression this is a bashing of Japan, but I was interested Tuesday when IRS gave us figures from the SOI division published July 1990. U.S. companies operating in Japan had sales of $28 billion.

During this same period we had sales from our companies operating in Canada of $108 billion, in the United Kingdom, $102 billion, in West Germany, $72 billion, but in Japan it was only $28 billion.

On the surface, it looks like Japan just doesn't want our companies over there. I think it ought to have been that they would ask that we would not put any obstacles in the path of their goods here even when our sales in Japan are one-fourth of that is most of the other countries.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. It is always a pleasure to have you before the committee.

Mr. Chairman, I ask unanimous consent that my statement be entered in the record, I regret I missed the opening but I was at another hearing.

Chairman PICKLE. Without objection.

[The statement follows:]

OPENING STATEMENT OF HON. DICK SHULZE

Mr. Chairman, I am pleased to join you in conducting our second day of hearings on the issue of whether U.S. subsidiaries controlled by foreign corporations may be understating their U.S. income.

On Tuesday we heard some rather sobering testimony. It showed that the U.S. subsidiaries of foreign corporations often report little, if any, taxable income on their income tax returns. This pattern is in sharp contrast with the growing sales and gross receipts of these controlled subsidiaries.

Mr. Chairman, something is wrong here. The pattern of growing receipts but negligible taxable income is not the result of some business cycle. It appears to be a deliberate attempt to avoid U.S. income tax.

This tax avoidance appears to be accomplished primarily by overcharging the U.S. subsidiary on its purchase of goods from the foreign parent. This violates section 482 of the Internal Revenue Code. Another tactic is to impose extra financial responsibilities on the U.S. subsidiary without adequate compensation from the foreign parent. These extra expenses include advertising campaigns and honoring the foreign manufacturer's warranty obligations.

Mr. Chairman, today we will hear from the Department of Treasury. I am anxious to learn what the Administration's position is on the transfer pricing issue and how it intends to improve compliance. We must work with the Administration to develop a legislative response to curb this abuse.

I welcome our witnesses today and look forward to hearing their testimony.

Mr. SCHULZE. I presume you have been briefed by the IRS as we have behind closed doors and have some of the facts that we are not allowed to discuss in public. I just want to know whether you share my feeling of outrage at the statistics, figures and facts which I have been given?

Mr. GIDEON. I think that it is clear from the data presented that careful examination of transfer pricing issues is warranted.

Mr. SCHULZE. I want to take that one step further. I have before me a pamphlet entitled "The Taxation of Controlled Foreign Corporations and the International Comparison."

On page 272 of that—I will read a small portion of it.

> Nonresident individuals and corporations are subject to Japanese income tax only when income derived from sources in Japan. As a result, the income of foreign corporations other than income derived from sources in Japan controlled by residents of Japan is not subject to tax until distributed to Japanese shareholders in the form of dividends.

Is that your understanding of Japanese law or are you not familiar with that?

Mr. GIDEON. I am sorry, I could not follow that passage without having it in front of me. We will be happy to look at the passage and comment for the record.

Mr. SCHULZE. It says,

> Income of foreign corporations controlled by residents of Japan is not subject to tax until distributed to Japanese shareholders in the form of dividends.

The way I read this, it says that on these sweetheart deals that are being made that not only is the U.S. tax being avoided but that Japanese tax is being avoided. There is no tax being paid on this.

Does Treasury agree or disagree with that?

Mr. **Gideon**. I don't know the answer to that, Mr. Schulze, but we will get back to you.

[The following was subsequently received:]

Response to Congressman Schulze

You noted that the Japanese tax system generally allows Japanese firms to defer tax on the income earned by their subsidiary corporations doing business outside of Japan until such earnings are repatriated to Japan. Thus, for example, the earnings of a United States subsidiary of a Japanese parent company would generally not be subject to the Japanese income tax until such earnings were remitted to the Japanese parent corporation in the form of dividends, interest, royalties, etc. Subject to certain exceptions, this does mean that the Japanese parent company can avoid Japanese tax on much of its foreign earnings—at the cost, however, of keeping those earnings out of Japan.

The United States also allows deferral of tax on the earnings of the foreign subsidiaries of U.S. corporations. Because it is recognized that "deferral" can be abused, both the United States and Japan have adopted certain anti-abuse rules. In particular, the "subpart F" provisions of the U.S. tax code and the "anti-tax-haven" provisions of the Japanese tax code are designed to preclude companies from unduly avoiding tax on their foreign earnings. One difference between the U.S. and the Japanese versions of these anti-abuse provisions is that the Japanese provisions only apply in the case of foreign subsidiaries located in certain specified tax-haven countries—and thus, for example, do not directly apply to a U.S. subsidiary of a Japanese company—whereas the U.S. provisions generally apply to all foreign subsidiaries of U.S. companies.

Mr. **Schulze**. It makes it so difficult to compete with that kind of an operation and that explains the figures that the chairman put forth. How could any American company compete with that type of tax structure? It is virtually impossible.

Mr. Gideon, you are aware that for sometime I have been an advocate of a consumption tax. One that might be formulated slightly different than the European type VAT, but would be similar in its border tax application.

It seems to me that this whole issue graphically shows that if we had a border tax, a value-added tax similar to the Europeans which is as high as sometimes 15 or 20 percent, that this would have a deterrent effect on gamesmanship with prices of goods being sent into the United States of America.

I am not saying that it would solve the entire problem. But I wonder if you agree that it would have the effect of influencing a company to keep the prices as low as possible when shipped into the country?

Mr. **Gideon**. As you know, Mr. Schulze, the issue of VAT is highly controversial from many standpoints. The one thing that you say that is irrefutably true is that under international agreements you can rebate VAT taxes at the border and you can impose them on imports as they are coming in. That simply is a fact.

There is some analysis that suggests that exchange differences may eliminate any perceived advantage in that but I think that theory itself is controversial. But the one aspect to which you are alluding is factual, they could be rebated at the border if they were imposed.

Mr. **Schulze**. Also it would leave a very definite paper trail, which now is somewhat elusive according to the IRS, in trying to determine pricing and values on products coming over.

Even if there were a 1 or 2 percent border tax, it would create a very definite paper trail so that prices and values could be determined.

Mr. GIDEON. Well, again, to allude to an earlier comment, any such tax would have to be nondiscriminatory; in other words, it would have to be on all goods of a given class. Within that certainly such possibilities are there.

Mr. SCHULZE. I am not going to get you to come over to my point of view, am I?

Mr. GIDEON. Not if I want to stay here.

Mr. SCHULZE. One other question that is somewhat related, Mr. Gideon. It comes under your purview. That is, we have been discussing situations where U.S. subsidiaries of foreign corporations are avoiding taxes by fixing the prices they pay to foreign parent corporations.

I would like to shift just a little bit and ask you about a situation where a foreign corporation chooses to conduct a significant portion of its worldwide operations out of the United States. They do this by setting up two or more U.S. corporations headquartered in the United States by the foreign corporations.

Now, last year's tax bill authorized the Treasury to take away the incentive such a foreign corporation has to make this type of investment and create employment in the United States.

Now, in my view, this would mean a loss not only of direct investment in the United States but also the goods and services that the U.S. subsidies buy from companies located in the United States.

I feel very strongly that we should not force foreign corporations who wish to have headquarters in the United States to run offshore operations. I feel very strongly that we should not force them out of the United States. In fact, we should try to encourage it unless there is some way that they are avoiding taxes.

It seems to me in these instances they are bringing in more income.

Mr. GIDEON. I am only aware of one situation like that that has been called to our attention, and I must say that our problems with the solutions that we have seen thus far is that we haven't come up with one that satisfies us that we won't be giving them an advantage in making the correction that would not be shared by domestic corporations.

However, it is an area where we are continually open to discussion.

Mr. SCHULZE. In your discussions and deliberations, let me suggest that you juxtapose what we are hearing here concerning foreign-based corporations with wholly owned subsidiaries not paying any tax. It creates a terrible dichotomy when we see that kind of thing.

These people want to be in the United States, want to create jobs, let's try to help them.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Gideon, as I know you know already, this is not just a theoretical discussion of nice tax issues, these things are quite serious.

In your view, are foreign-owned or foreign-controlled U.S. subsidiaries paying their fair share of taxes?

Mr. GIDEON. That is a question that I cannot answer.

Mr. FLIPPO. What further information do you need in order to make a definitive answer or reach a definitive conclusion?

You have as much information or more than any Member of this committee has available. Do you have evidence to indicate to you in fact that the average working man and woman in the State of Alabama pays more, has paid more personal income taxes over the last 5 years than many of the corporations, multinational foreign-owned corporations, operating in the United States?

Mr. GIDEON. There certainly have been some situations where there is a remarkable drain without profitability——

Mr. FLIPPO. So you have information at your disposal that does clearly indicate that what I stated is correct. In many, many cases the average working man and woman in the State of Alabama paid more income tax over the last 5 years than multinational corporations. Is that a fact or not?

Mr. GIDEON. There are circumstances we are aware of where there has been little or no tax payment over a number of years.

Mr. FLIPPO. So the answer to that is yes?

Mr. GIDEON. That would be one way of putting it.

Mr. MCGRATH. Would you yield?

Don't you have information which suggests that there are companies, foreign companies doing business in the United States for the last 10 years that haven't paid 1 cent of income tax?

Mr. GIDEON. I am aware of some of the data that was presented to you on Tuesday, yes.

Mr. FLIPPO. So the answer to the question is yes.

Don't you feel then an obligation as you and Treasury and the Internal Revenue Service—indeed every member of this committee, everyone in Government—don't you feel an obligation to assure the American taxpayer that you are going to put a stop to that?

Mr. GIDEON. We have supported the kind of legislation that we think will——

Mr. FLIPPO. What are you supporting today that will assure the American taxpayer that we are not going to tolerate that kind of operation? What do you propose to this committee that we do?

What I want to ask you is, is section 482 adequate to assure the American taxpayer of the equitable burden that he bears?

Mr. GIDEON. We think that the key is adequate information, and if properly audited and applied, we ought to get good results. That is certainly the information——

Mr. FLIPPO. I guess my question to you is, if section 482 is adequate to do that job, then why hasn't it been done, and if it is inadequate, what do we need to do to fix it? Because it is certainly an intolerable situation, isn't it?

Mr. GIDEON. I think that it is clear that this area deserves substantial audit activity. As you have seen by the statistics, it has been getting it for a while. It takes a while for those examinations to bear fruit, but I think they will.

Mr. FLIPPO. These transfer pricing abuses affect our country's trade competitiveness, don't they?

Mr. GIDEON. In situations where there are abuses and someone is trying to do that on a continuing basis, no question it would affect it.

Mr. FLIPPO. Looking at 1990, who is being hurt under present practices?

Mr. GIDEON. That is a question I find hard to answer in the abstract.

Mr. FLIPPO. Let me ask you, are U.S-owned companies with subsidiaries overseas employing the same methods and the same schemes to move profits offshores?

Mr. GIDEON. Well, we certainly hope they are not and we have a history of examination there that would give us some confidence——

Mr. FLIPPO. Then what is Treasury doing to address this problem?

Mr. GIDEON. I think the Commissioner's testimony set forth a concrete plan.

Mr. FLIPPO. What do you view as the biggest compliance challenge facing Treasury and IRS in addressing those issues?

Mr. GIDEON. Getting the data, which I think was the key to section 6038A that was enacted last year.

Mr. FLIPPO. Suggestions and changes that were made in 1986 as it impacted both—getting into the intangible area, you referred many times in your testimony today to the white paper.

In the white paper, you seem to be coming up with a new standard in addition to the arms-length. You seem to be coming with a standard where you want to allocate income, that is appropriate—what is the phrase you used—commensurate with the income attributable to the intangible.

Are you familiar with what I am talking about?

Mr. GIDEON. Yes, Congress in fact put a phrase like that into law in 1986.

Mr. FLIPPO. Do you agree with it?

Mr. GIDEON. I wasn't around at that time.

Mr. FLIPPO. Do you agree with it now?

Mr. GIDEON. I think we have to pay careful attention to that. The problem we are faced with is that we were looking at that in 1986 as an outbound issue. In other words, we were concerned that we weren't getting enough out of U.S. intangibles going abroad. We face the converse of that problem, so that if we are overaggressive on one side, it is going to cost us on the other.

Mr. FLIPPO. Under that standard—I believe the white paper discusses being able to reallocate income on intangibles, like a U.S. corporation licensing an intangible overseas. Under that standard, Treasury could reallocate up to 92 percent of the income back to it.

Will foreign-owned corporations use that same standard to avoid tax?

Mr. GIDEON. That is one of the criticisms that was made of the white paper and one that we are giving serious attention to.

Mr. FLIPPO. What I am trying to get to is that the suggestions that we keep trying to deal with 482, we don't seem to be making any progress in attacking this problem with 482. Maybe we ought to be looking at another approach to this thing instead of trying to patch this thing up and see.

I appreciate the gentleman's testimony.

Chairman PICKLE. Mr. Flippo, thank you.

Earlier today, I had asked the Assistant Secretary several specific questions that would ascertain his position if we advanced some legislation, and I am glad to have his responses on the record. You keep mentioning the white paper and that you are studying this and want to advance the changes, and I appreciate that, but we run into the question, what should we do about it?

For example, you, Treasury, issued a white paper back in 1988 and you recommended taxpayers should be required to document transfer price methodologies prior to the filing of a tax return. During examinations, and you listed certain things, reference to comparable transaction, rates of returns, profit splits, and other analyses. Those were your specific recommendations.

Apparently, they have not been followed or put into effect. Rather than wait for Treasury to put into effect these kinds of recommendations, why don't we statutorily require the very things that you recommend? Would you object to that?

Mr. GIDEON. I think that the purpose of the white paper was to get discussion. We have had a lot of discussion on that point. We received some help.

I would say, however, that getting some documentation of methods used to set prices in advance continues to be an area of great interest in terms of the sort of thing that may come out of the white paper.

Chairman PICKLE. Mr. Gideon, I think you will see the committee being most firm in this approach statutorily than you have been in your answer.

Thank you.

Mr. FLIPPO. Mr. Chairman, would you yield for a second?

I just wanted to see if I could clarify. I think the chairman asked you whether or not you wanted that information on the return. What was your reply? Maybe I didn't quite understand it.

Mr. GIDEON. We are interested in looking at that. The service is at this point, I think, studying proposals as to what would make sense to put on the return.

The problem, of course, is trying to make sure that you are getting relevant data that will in fact be useful because you don't want to require a bunch of stuff that is not going to be helpful. But to the extent that it could be targeted in a way that is helpful, we are interested in that.

Mr. FLIPPO. Could the committee expect to receive that information in the very near future in time to deal with it legislatively?

We are counting on you to tell us your opinion of whether or not we need the information.

Mr. GIDEON. I will be happy to confer with the Commissioner. I would suggest, however—I understand the committee's enthusiasm for legislation, but in the information-gathering area, the flexibility of the regulatory process ought to at least be considered as an alternative.

Mr. SCHULZE. Will the gentleman yield?

Mr. Gideon, let me try to express to you some sense of urgency. We are dealing with a massive deficit that is increasing dramatically. From our standpoint, we see a large untapped source of income which legitimately should be paid. These corporations are paying less than the average taxpayer in the United States.

If we are going to be called upon by the administration and by our summiteers to increase taxes, I will be damned if I am going to do it while billions of dollars are floating overseas. There is a sense of fairness and equity and urgency. So I would ask you, please get us some information as soon as you can.

Chairman PICKLE. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to magnify Mr. Schulze's frustration with this particular issue, which reflects the entire feeling of this committee.

We have met in open and closed session with your agents, your examiners. We know their frustration. They are outmanned.

Their biggest enemy right now seems to be time. But there seems to be a certain amount of patience over at Treasury which is not shared by this committee, and it is costing the American taxpayers billions of dollars every year, because another tax year becomes history and out of reach by the Internal Revenue Service because of the statute of limitations.

I quite agree with you and I am sure we all share your sensitivity as to not wanting to discriminate. That is a given.

But the way that these companies are operating and trying our patience, I find is incredible. The way they do not supply the information that they are required to file and required to give the IRS for years should be trying very heavily upon the patience of the IRS as well as the entire Department of Treasury.

Mr. GIDEON. Mr. Shaw, some of that frustration led to 6038A last year. It was a problem we saw and we supported its enactment in the code. It deals with that specific frustration.

Mr. SHAW. To paraphrase, what we are looking for and have not seen is an expression of outrage by the IRS and by the Treasury with regard to what is happening here.

What we do see is that we have to find tens of billions of dollars and we can document right here that in all probability, at least that much is due from many of the foreign companies operating here in the United States in the form of income tax.

You also see the tremendous technology that is being developed and the tremendous accumulation of capital that is going on by overseas countries. We see that that capital is being accumulated simply by not having to pay Federal income tax. That is a tremendously unfair burden that we are placing upon American industry.

There is no way that our automobile industry, or our electronics industry can compete with Asian industries if they are have to pay corporate income tax when these Asian industries are not. We know that the problem goes to European countries as well but not to the extent that the Asian countries are getting away with it. It is killing us competitively and financially.

The dollars are being retained there and lent to us. It doesn't make any sense.

While I can well understand you don't want the Congress micromanaging the Treasury by earmarking certain dollars to go certain places, I believe if we are going to really get serious about it, then unless we have some indication from Treasury that that is exactly where that money is going to go, or a request from Treasury that they want it, then they won't get it.

Mr. GIDEON. Let me state clearly the administration is for vigorous enforcement of the law in this area. My testimony today is intended to underline that fact.

It is clear that the data indicates that there should be examination and as the Commissioner indicated Tuesday, he intends to do it.

Mr. SHAW. It is perhaps your low-key approach to problems that probably is more in just keeping with Ken Gideon, a very calm, cool type of person. We want to see someone pounding on the desk, and that is not your style.

I will take you at your word. But I would hope that the Treasury would return here to the Congress some type of plan with dollars attached to it recognizing the urgency of this and what it is that you plan to do.

It is vital that we not only worry about keeping these people by some type of a formula to increase compensation for the old-timers that are sticking with you, but we also need some way to bring in experts now so that the statute of limitations doesn't continue to run on these companies. Otherwise more and more tax returns of past years are put out of reach of the IRS and therefore they have to write them off as monies not collected.

Mr. GIDEON. I certainly concur on the pay points. I think there is probably no more critical issue in terms of getting the IRS in a position to do its job than solving the compensation issue.

Mr. SHAW. We have got to keep the people there. But I want to underscore this. I believe it is something that this committee is going to have to be concerned with as well as Appropriations Committees. We need to do something about bringing people on board right now who have some experience behind them so they can get involved in some of these prior year cases.

Mr. GIDEON. I don't have any disagreement with that, but it all comes back to the same compensation issue.

Mr. SHAW. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Secretary, you said that you thought the IRS ought to vigorously pursue these 482 cases. Are they vigorously pursuing them now?

Mr. GIDEON. I think they are trying. I thought that was the import of their testimony on Tuesday.

Chairman PICKLE. Do they have enough personnel to vigorously——

Mr. GIDEON. Part of the question there as we have stated again is this may not be as much a matter of how many, although I think certainly one can always look at the issue of whether more resources might help, but the real issue is the one we have been talking about with Mr. Shaw; they have got to have quality personnel resources and to do that, they have to have the compensation tools.

Chairman PICKLE. We don't disagree on the import of that statement, but your people Tuesday testified they need more personnel, more expert personnel, more economists.

The IRS has 40 economists to handle section 482 cases in addition to other duties. Any major accounting firm in the United

States has probably 40 economists on their own payroll available. Obviously we are undermanned or outgunned.

Now, the Commissioner admitted that yesterday and the field people who handle these cases directly admit that. I don't think we have to play games here and say we are doing the best we can. I don't believe that we are unmindful of this problem.

I admit that the IRS has doubled the number of people in these 482 cases in the last 5 years, but that is a woeful approach to this problem. This is a problem of international significance not only for multinationals but for our own companies.

Mr. SCHULZE. Let me agree with what the chairman is saying.

Part of my frustration, Mr. Secretary, is the fact that I got a great sense of frustration from the IRS agents who were actively working on these cases, a long-term frustration.

My concern is that the IRS or the Treasury has not come to this committee and said, "Give us the tools to operate efficiently to collect this money," and that causes me great concern. Either the lines of communication are not open or Treasury or IRS is not listening.

I suggest that you try to get those lines of information open and get information to us so we can correct the situation as soon as possible.

Chairman PICKLE. Before I recognize Mr. Jacobs, the committee would like to move forward. For as much time as you wish within your 5-minute limitation.

We have the majority leader here to testify and the distinguished Senator from North Carolina along with us so we want to move along.

Mr. Jacobs, we will be delighted to recognize you now.

Mr. JACOBS. As long as we are introducing honored guests, we also have the gentleman from Michigan, Mr. Bonior, with us today. We are pleased to welcome them.

Mr. Secretary, under present law, as an American corporation pays an income tax to a foreign state, it may credit that tax against income obligations, income tax obligations in the United States. If, on the other hand, that corporation pays a tax to a domestic state, say Michigan or North Carolina, it can only deduct that tax paid to that State.

In order to make things fair, would you change the foreign situation to a deduction or the domestic situation to a credit assuming you love our States as much as foreign states?

Mr. GIDEON. Well, with no——

Mr. JACOBS. Is that an assumption that is fair?

Mr. GIDEON. With no disrespect to the States intended, I would not change the current situation.

Mr. JACOBS. Then you consider it fair.

Mr. GIDEON. Yes. In the international context, we are dealing with large-scale tax burdens where the issue of eliminating double taxation is an important concern to make sure that capital can flow freely across borders and that trade is not inhibited.

On the other hand, fortunately our State income tax burdens have remained relatively modest and the deduction system has worked reasonably well.

Mr. **Jacobs**. Of course, our State income tax burdens would not be so modest if they could be credited against obligations to the U.S. Government, isn't that reasonable to assume?

Mr. **Gideon**. That is probably fair. Then this committee would have a great burden of replacing the cost. .

Mr. **Jacobs**. perhaps it could be done by making the foreign tax payment deductible.

Mr. **Gideon**. Were we to do that we could expect a similar response from our treaty partners.

Mr. **Jacobs**. Without question, but there would probably be somewhat less exportation of American jobs if we did that, is that fair to say?

Mr. **Gideon**. I think that is not at all clear under the circumstances.

Mr. **Jacobs**. Even if it is murky, is it fair to say?

Mr. **Gideon**. I would disagree with that. I think that it is not at all clear.

Mr. **Jacobs**. If it is less attractive for an American corporation to export jobs, it is not fair to say it would be less likely to export jobs?

Mr. **Gideon**. I don't think that the exportation of jobs is directly implicated by foreign tax credit. I think that expanding trade has generally been beneficial to all economies including this one.

Mr. **Jacobs**. That includes among the states?

Mr. **Gideon**. Yes.

Mr. **Jacobs**. That was the principal issue, was it not, in our Constitutional Convention?

Mr. **Gideon**. Yes.

Mr. **Jacobs**. Well, Mr. Chairman, I like the majority leader's tie so much, I will yield back the balance of my time.

Chairman **Pickle**. The Chair appreciates the gentleman's courtesy, his questions, and his participation.

The Chair would like to recognize the majority leader of the U.S. House of Representatives, Richard Gephardt of Missouri.

I understand Congressman Bonior would like to be with you at the same time.

Senator Helms, Mr. Hunter might appear with you at the same time.

Mr. Gephardt, if you would take your position and Mr. Bonior, we are delighted to have you. You may proceed.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI, AND MAJORITY LEADER, U.S. HOUSE OF REPRESENTATIVES

Mr. **Gephardt**. Thank you, Mr. Chairman.

It is always a high honor to come back to the Ways and Means Committee on which I served for a number of years with everyone here, and to tell you that I appreciate very much the opportunity to have this chance to talk about this legislation and admire the work that your subcommittee and committee is doing on this legislation.

Mr. Jacobs, I would like to have my tie recognized in the record, if that would be all right.

Mr. JACOBS. We could scarcely miss it, sir.

Mr. GEPHARDT. I am joined by my distinguished colleague, Mr. Bonior, who is from the State of Michigan and who has worked in putting together this legislation that we presented, along with the chairman of this distinguished committee.

For several years, we have fought for fair treatment for our farmers, workers and business overseas. We have fought to get markets opened to our products, given the opportunity to complete, we know the power of American ingenuity and hard work will win out every time.

As we continue the fight to regain our competitiveness and fair treatment for our people and our products overseas, we can't ignore problems of tax and trade unfairness here at home. This fight, we feel, is just as important as the fight to open foreign markets.

The investigations being conducted by your subcommittee, Mr. Chairman, are vital to the future competitiveness of the United States.

As the IRS Commissioner, Mr. Goldberg, testified before you 2 days ago:

> The aggregate data, and our own examination activities, suggest that foreign-controlled companies have adopted transfer pricing and other practices that may significantly understate their U.S. income tax liabilities. While we cannot yet estimate the magnitude of the problem, we believe that the shortfall is substantial.

Our constituents, our workers, and our taxpayers, all want to know why foreign-controlled corporations don't pay their fair share of taxes the way American corporations are supposed to do. And further, they want to know why something isn't being done about it.

In March of this year, Chairman Rostenkowski, Chairman Pickle, Dave Bonior and I were joined by a number of colleagues in introducing H.R. 4308, the Foreign Tax Equity Act. This legislation is designed to give the IRS the tools that it will need to pry open the books of foreign-controlled companies operating here and to make sure that they pay their fair share.

IRS data show that in 1986, foreign-owned companies operating here reported approximately $550 billion in gross receipts, but had negative net income of $1.5 billion.

As you pointed out, Mr. Chairman:

> Some of the companies investigated have been operating in the United States for years and have never sent a check to Uncle Sam for "one thin dime" in corporate income taxes. They have failed to pay taxes despite the fact they have profited from selling billions of dollars of cars, motorcycles, stereos, televisions, VCRs, microwaves, and other products to the American consumer.

Mr. Chairman, your statement was right on the mark. And, before we start raising taxes on the middle class, as some advocate, I believe we should look to profitable U.S. operations of foreign-controlled corporations that don't pay any at all.

The principle we are expressing is simple: if you want to sell to our consumers, you have got to play by the rules.

The operations of foreign-controlled corporations are a problem not only because of their failure to pay tax—and the resulting loss of revenues and enhanced competitiveness. They are also a problem in exacerbating our foreign trade deficit.

Last year, Business Week ran a story indicating that "foreign affiliates accounted for almost 45 percent of the deterioration in the trade balance in just 5 years."

Things have only gotten worse. The economist who did the study last week told us that more than 50 percent of our trade deficit is now accounted for by foreign affiliates and the parts and the products that they bring into the United States to fuel their factories. These companies are locating here, not paying their taxes, and not buying our products.

Foreign corporations that come to this country, and benefit from the quality of our workers, the strength of our transportation system, and the wealth of our natural resources ought to pay something in return. It's simple fairness.

What does this really mean? Let's look at the auto industry. Foreign-controlled corporations operating here claimed total receipts of about $7.7 billion. On this amount, they paid less than $12 million in taxes. By one measure, U.S. auto companies paid 530 percent more on their operations. No wonder they are having a hard time competing.

The Foreign Tax Equity Act, along with other options that develop from your investigation, will help us regain our competitiveness.

We can't afford not to pass our legislation. We are now engaged in a budget summit to lay the base for a long-term deficit reduction plan. We need the added revenue that the provisions in our bill will give us. The Joint Committee on Taxation says our bill will raise more than $1 billion over 5 years. I think it will raise a great deal more.

I don't want to ask the American people to tighten their belts to help get our deficit down until those who aren't paying their fair share start ponying up.

I believe that the policy of the Reagan and Bush administrations has been to sweep this problem under the rug. As one IRS employee testified the other day:

> We received constant pressure from various elements in the IRS to close these examinations before they were fully developed. During the course of these examinations in the late seventies and early eighties, there were threats of job loss and examination team transfers if these cases were not closed, even though not fully developed.

This same IRS employee indicated that the problem, in part, was due to protests from foreign governments.

I was pleased to hear of Commissioner Goldberg's support for some of the provisions of H.R. 4308. His support may help to reverse the policies of the past and put us on a more level playing field.

It is time that we addressed these issues. The American people deserve no less.

Again, I thank you for the opportunity to be here and I look forward to working with the subcommittee and the committee in trying to develop this legislation.

Chairman PICKLE. Thank you very much, Mr. Leader, for that excellent statement.

We appreciate your direct and your personal interest in this issue.

It may be it would be a billion dollars of revenue for us. It may be more; and I agree with you.

Chairman PICKLE. Mr. Bonior.

STATEMENT OF HON. DAVID E. BONIOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, AND CHIEF DEPUTY MAJORITY WHIP, U.S. HOUSE OF REPRESENTATIVES

Mr. BONIOR. Mr. Chairman, I want to commend you for holding these hearings and for bringing attention to bear on how some of America's toughest competitors are withholding billions of dollars from the U.S. Treasury.

Your 9-month investigation of the tax noncompliance by foreign-owned subsidiaries demonstrates how serious this problem has become.

These tax schemes are costing us money, costing us jobs, and they are hurting America's competitive edge. Closing these tax loopholes is a critical component in reducing our overall budget and trade deficits.

While foreign-owned assets in the United States more than tripled in the last decade, the taxes paid on these investments hardly changed. The rate of taxes that the average American pays is far greater than these huge multinational corporations.

Mr. Chairman, as the report correctly points out, of the 36 foreign-owned companies investigated by this subcommittee, more than one-half paid little or no Federal income tax in the last decade. IRS officials estimate that by collecting underpayments from the last 5 years, the revenues raised could total up to $12 billion.

Before we even start talking about raising taxes on the American people, we ought to take a hard look at the foreign companies operating in this country who are not paying their fair share.

Mr. Chairman, in my home State of Michigan, the auto industry has been especially hard hit by these tax evaders. As the majority leader has pointed out, 1986 tax returns show that foreign-controlled auto firms operating in the United States claimed income of $7.7 billion, but paid only $12 million in taxes.

By contrast, U.S. auto companies paid 530 percent more in total income tax.

Japanese auto firms are not paying their fair share of taxes. Michigan taxpayers are indirectly subsidizing the very foreign competitors that have cost us jobs in the auto industry.

In one case reviewed by this subcommittee, a foreign automobile manufacturer sold cars to its U.S. distributor at prices averaging $800 more than identical cars shipped to Canada, right across the border. As a result, that manufacturer will show less profit and therefore pay less tax than American firms with whom it is competing. In the end, jobs will be lost.

We should be telling Japan if you sell your cars in the United States, you are going to pay the same taxes we pay in this country.

Foreign-owned subsidiaries use every means conceivable to avoid paying taxes—from increasing freight, insurance, and interest costs to providing records to the IRS in foreign languages, if they are provided at all.

Unfortunately, the IRS is outgunned. While the number of foreign-owned subsidiaries in this country has soared in the last decade, the number of international examiners at IRS has remained flat, between 400 and 500, for the last 4 years.

Apparently, the IRS has no one inhouse who can translate tax reports in foreign languages. How can we figure out abuses if we can't read the reports?

The IRS has a total of 40 economists—the equivalent of what a single accounting firm may employ. How can we expect to catch tax evaders if we don't have enough regulatory cops on the beat?

In many ways, we face a situation similar to the savings and loan fiasco where taxpayers are losing billions because there is inadequate regulation and oversight.

Recently, Mr. Chairman, you and I joined Majority Leader Richard Gephardt and Chairman Rostenkowski in introducing the Foreign Tax Equity Act of 1990 to crack down on these tax-evasion schemes. It is my hope Congress will enact such legislation in this session.

Congress enacted legislation last year which granted the IRS broader authority to assess taxes and issue fines up to $10,000 a month for companies that fail to comply with a demand for records.

But this was not enough. We need to go further.

H.R. 4308 would enhance the ability of the IRS to investigate tax returns of foreign-owned subsidiaries operating in this country, extend reporting requirements for any year in which an audit is still ongoing, and extend the statute of limitations for up to 6 years.

In short, it would increase the ability of the IRS to investigate abuses and to obtain the financial records of foreign firms. The IRS must be given the tools to find out if parent companies are inflating prices charged to their American subsidiaries for goods, parts, and services in order to unfairly reduce their taxable income.

Our legislation would also impose a tax on capital gains made by foreign investors from the sale of stock in U.S. corporations. Americans have to pay tax on capital gains. Foreign investors should have to pay as well.

In 1989, the United States ran a $108 billion trade deficit, 45 percent of it with Japan.

Foreign investors have purchased the Rockefeller Center, Columbia Pictures, and now the 7-Eleven chain of convenience stores.

America's wealth is being sold down the river.

If we are going to make headway on the budget deficit, foreign companies must pay their fair share of taxes.

If we are going to tackle the trade deficit, we have got to close the loopholes which give foreign companies a competitive advantage in this country.

Americans thrive on competition. But they want the rules of the game to be fair.

It is time to make foreign investors pay their fair share of taxes.

It is time to get tough on our trade competitors.

It is time to protect the jobs of middle-income Americans.

Thank you, Mr. Chairman and committee members for your indulgence.

Chairman Pickle. Thank you, Mr. Bonior, and we certainly thank the majority leader also for being with us today.

Both of you have joined with the chairman of the committee and some of us to advance a solution to this problem.

It is my hope that we can advance some kind of proposal along the lines the chairman has introduced.

Mr. Leader, I assume that if we can advance a bill, you would give it priority on the floor and try to give it immediate attention.

Is that my general understanding?

Mr. Gephardt. We will get it on the floor with dispatch.

Chairman Pickle. Would we also get it out of the House with dispatch?

Mr. Gephardt. I will do everything I can to see that is the result.

Chairman Pickle. We are not trying to bash any one country or discourage international trade, because free trade is the heart beat of this great country and the world.

We must be careful that we are not trying to put up impediments that would stop trade, but it is fair to say that anyone who does send us goods should pay their fair share of taxes.

That is what we are asking for and what the nations of the world would agree to.

I think they will find that to their advantage as well as to the United States.

Mr. Schulze.

Mr. Schulze. I thank my colleagues for their statements.

Quite frankly, Dick, I don't believe your legislation goes far enough.

I believe it is a good beginning, but just extending the statute of limitations doesn't really give the IRS the tools to force some of these companies to disclose those things that are necessary.

I believe it should go even further.

Mr. Bonior, are you part of the summit?

Mr. Bonior. I am not a summiteer, but less than an hour ago in the Rules Committee, we waived points of order against an amendment that was established in the Treasury and Postal Services appropriations bill which appropriates $10 million to the IRS to get on with their problem.

Mr. Schulze. I hope it will do some good, but when we asked the question of how long it would take if we gave additional funds to have the people trained and have an impact, I am afraid the answer was 3 to 4 years.

I am glad that you are appropriating that money and we should go in that direction, but I believe we need more stringent tools right now.

I have been an advocate of a consumption tax for some time, one which would be applied at the border similar to the European-type VAT.

This is a perfect example of how that would not only create a paper trail, whether 1 percent or 5 or 20 percent, but if a company wanted to, they would pay a higher border tax when they overcharged their subsidiary. As a consequence it would create a disincentive for such actions.

I hope, as you summit, you will keep in mind my proposal which would eliminate the corporate income tax, replace it with a slight consumption tax and in the process bringing the same amount of money from the corporations, while also increasing the efficiency of American business communities immediately, but the ramifications of the border tax is that it would bring in an additional $40 to $50 billion on these products coming in from overseas so technically it would not be a new tax on the American people. It would bring in additional funds and level that international trade playing field that we so badly need as nearly almost all of our major trading partners now have because they apply some form of value-added tax or consumption tax.

So I hope as the summit moves forward and we can pick up a billion dollars here, frankly by creating a tax on foreign products, which is GATT-linked. We can help solve some of that budget crisis without dramatically impacting on the American public.

Mr. GEPHARDT. I appreciate your suggestion. I reiterate something in my testimony that I found to be remarkable and that is the statistic that half of our trade deficit comes from the parts that are coming into the United States going to foreign-owned plants in the United States.

That gives you a sense of the volume of this situation.

Mr. SCHULZE. I believe the gentleman was not here when I read into the record a section describing Japanese tax law stating that income from foreign subsidiaries is not taxed in Japan until it is distributed to shareholders.

As a consequence, there is a massive amount of money which allows that cash flow, that availability of capital for modernization and implementation of new projects, available in a way that doesn't begin to become available to companies in the United States.

I believe it is abominable.

I have one question.

On your visit to Japan which was much publicized, did you bring this issue up with the Japanese?

Mr. GEPHARDT. I did not.

I wasn't aware frankly at the time of the magnitude of the problem or even that there was a problem.

It came in the last 8 months to a year that I really——

Mr. SCHULZE. If you go over there again, I hope you will raise this issue.

Mr. GEPHARDT. I am sure I will if I get a chance to go back in safety.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

I welcome our good friend Dick Gephardt back to the committee and David Bonior. I would like to read into the record, to reenforce both of your statements some facts that will be forthcoming from a witness from the Commerce Department.

I think, Dick, that it really strengthens your argument. You may be aware of these because you have used some of them in your testimony. But I think it really dramatically points out why we need to do something.

In 1980, the United States accounted for 43 percent of of worldwide outward direct investment, and only 16 percent of inward investment. By 1987 USDIA was only 32 percent of the worldwide total, while $1 in every $4 of inwardly directed investment flowed into the United States. So you can see a dramatic turnaround from 1980 to 1987. In looking at just the 1987 data alone, what is striking about this data is how imports are accounted for by parent affiliated trade. Of total U.S. exports the equivalent of 19 percent came from affiliates of foreign corporations in 1987.

Eight percent of those exports were to the foreign parent corporation. Imports by U.S. affiliates were the equivalent of 35 percent of total U.S. imports in 1987 and 26 percent were from the foreign parent.

David, you were specifically worried about the automobile industry. I think this is something you will find interesting. An examination of trade with individual countries tells an even more dramatic story. Exports by Japanese affiliates were the equivalent of 69 percent of all U.S. exports to Japan, while imports were 81 percent of total U.S. imports from Japan. This same pattern is true for some other countries as well, particularly for imports. For example, the equivalent of 60 percent of U.S. imports from Germany are to U.S. affiliates of foreign firms.

David, you mentioned you just waived points of order on an appropriation. I appreciate that; $10 million is earmarked. I would hope that within the earmark for audits for section 482 there could be an additional earmark and based on this following statement: Not surprisingly, about 50 percent of the affiliated imports are finished automobiles since most Japanese and German cars are imported by distributors of their own by manufacturers. If there is a case for abuse under section 482, as we are all led to believe by the testimony, then I would encourage that the earmarking even go specifically for additional auditors and a strike force which would go specifically to the 50 percent of the total.

If we are to get a dollar return on a dollar invested, it appears that it would be in the automobile industry that would be the most likely.

David, just to give you an anecdote you might want to use back home, you talk about the IRS not having in-house personnel that can translate tax reports, we were given the following information about an audit that was taking place. The original translation came from the Japanese lawyer. The Service in the United States did have the papers translated—now whether it was in-house or contracted out, I am not aware—but I want to read two phrases that did not find their way in the Japanese lawyer translation but were discovered by the translators in the United States that were retained either in-house or contracted out by the Service. "The removal of profits from the United States to cover losses of the Japanese manufacturer's importing operations in other countries," that told the Service that they were forcing a higher cost on the imported product so that they could create a loss here to cover losses in the manufacturing area that were offshore and in another country.

But the one that really gets me, and I quote, "In light of IRS examinations of other Japanese automobile importers, it is unlikely our pricing procedures could stand up to scrutiny."

I just find it amazing that a Japanese translator, until I found out he was a Japanese lawyer, would omit that particular section. If that doesn't give you ammunition to say that they internally believe that their own pricing system is being used to out man, out gun and to gain our system, I think it gives you additional fodder and information and basis for your legislation.

I thank you for your effort in this area.

Mr. **Bonior**. Thank you. I will use it well.

Chairman **Pickle**. Mr. McGrath.

Mr. **McGrath**. Thank you. Welcome back to the committee, Dick.

In the hearings that we have had over the past week, in our private discussions with the IRS and in looking at some of the returns of the 36 companies that we have been investigating, there seems to be more than just this scheme of pricing in the avoidance of taxation here in the United States.

Mr. Anthony has alluded to some of them. But the extensive use of NOL's carried forward and carried back seems to be a tool which they are using in order to accumulate NOL's and then in 1 year show a profit and then use the NOL's to wipe out any kind of tax liability. We have seen in some instances where foreign companies operating in the United States have not paid 1 cent of taxes, not 1 cent of taxes to our Government.

If I could express for the committee the outrage that we have, I don't think I could overstate it enough. I want to thank you gentlemen for bringing to the attention of the House this outrage and of course to congratulate the chairman for carrying forward.

Chairman **Pickle**. Thank you, Mr. McGrath.

Mr. **Gephardt**. If I may say one thing, Mr. Schulze and others, we have no objection to finding additional tools to deal with this problem. Obviously we are delighted that the committee has taken such an interest and is looking so carefully at all this material.

We will look forward to the development of legislation out of the committee.

Mr. **Schulze**. We will be happy to have any additional reports that you have to strengthen this legislation.

Chairman **Pickle**. Mr. Flippo.

Mr. **Flippo**. I want to commend the gentlemen for their testimony. Mr. Majority Leader, your record of fighting for fairness in trade and taxes is well known and well documented. We appreciate that. The Commerce Department has told us that foreign direct investment in the United States has increased over $300 billion during the 1980s.

So this transfer pricing problem that you are trying to address is getting more difficult all the time. We do appreciate your leadership.

Many people feel that section 384 and the growing international markets tells us that the transfer pricing problem is just going to go on and on. It is not a problem that is unique to America. It involves other countries as well. Some have suggested that perhaps we should have some type of blue ribbon commission and for the United States to take the lead, working with our trading partners to develop a totally new approach to this kind of problem.

I know Mr. Schulze talked about a border tax. The countries that already have a border tax and a value added tax also have a transfer pricing problem. So it is not—and I know Mr. Schulze was not trying to suggest that it was a panacea but it is not a total answer to our problems. I wish the majority leader would give some thought to taking the leadership in a blue ribbon commission that would bring others into examine this problem from an international point of view as well.

Mr. **Gephardt**. I think a broader approach and a more thoughtful look at the whole thing is needed. Let's understand what is going on. The reason that foreign corporation have put plants in the United States is that they may feel it is more efficient to develop the product here, put the parts together, and it solves some trade-political problems. We understand that.

For the most part we have applauded their willingness to bring plants here so at least we get the final assembly activity. However, to the extent there is activity in the United States, and sale in the United States, we feel that the infrastructure and the resources of the United States that have helped bring this about need to be compensated in a fair way.

So we need to look at all of this perhaps in a larger context. But for right now we have the tax laws we have. We think they are being abrogated, walked around and violated. We think this needs to be done.

Chairman **Pickle**. Mr. Flippo, I thank you for your question and your inquiry about the blue ribbon commission. I think this committee may give favorable consideration to this approach.

We have discussed this with Treasury and IRS. We do not want to slow down any implementation of the white paper that Treasury may be considering. I don't think we need to slow down the process, we need to speed it up. I think it would be helpful if we broaden our inquiry with experts, not only on commerce, tax, but IRS and people who are experts in this field.

I think that will be a consideration we will give serious thought to. Mr. Dorgan, do you have any questions?

Mr. **Dorgan**. This entire area is very interesting for me especially because I was a State tax administrator. In fact, I was chairman of the first organization to create joint audits of multinational corporations between the States so instead of one State going in and auditing and being told one thing and another State coming in later and being told something completely different, we would go into joint efforts.

We discovered that some of the largest enterprises in this country and the world were telling states different things and using transfer pricing routinely. They would say to California officials, we attributed that business to North Dakota officials. Then they would say to North Dakota, that is California business. Using apportionment and allocation they ended up with lots of no-where income.

It appears that on an international scale this is being played in a much more sophisticated way to avoid tens of billions of tax dollars. This is not arithmetic error or a mistake by someone who is ill-trained. This is systematic tax avoidance on a massive scale.

Someone on the committee indicated earlier that while it seems that you can only put people in jail for little things, because massive tax avoidance and schemes that are very sophisticated are often attributed to the difficulty of developing formulas and so on. I think what you have brought to the attention of Congress is of extraordinary importance. We are probably talking about $25 to $30 billion in revenue that we ought to have that probably represents no-where income, that is they are not paying it to the home country and they are not paying it to the country in which they are doing business.

It is fundamentally unfair to the American businesses competing with foreign competition that foreign competition is not paying the same tax burden. And it is a disaster when we are choking on debt in this country to have $25 to $30 billion that ought to be in our treasury that is in the pockets of somebody overseas.

I want to commend your work and once again commend the chairman for these hearings.

Chairman PICKLE. Thank you, Mr. Dorgan.

Mr. Bonior and Mr. Leader, I want to thank you for your testimony and your cooperation. As we move forward in this area we will keep in close touch with you. The Assistant Secretary of the Treasury, Mr. Gideon, indicated he was in agreement with many of the recommendations in the bill introduced by our chairman.

Though we may have some slight differences, I think there is a general agreement that we should proceed on a positive basis and we will keep in close touch with you.

We thank you for your leadership and your appearance today.

Now the Chair wants to recognize Congressman Duncan Hunter of California. Do you want to have Senator Helms join you?

Mr. HUNTER. Absolutely.

Chairman PICKLE. Senator, we are glad to have you here. I want to apologize to you, Mr. Hunter, and to the Senator for the extended hearing we have had this morning. We are trying to move as quickly as we can. I want to say to you at first, Mr. Hunter, I notice we have been given a copy of the Duncan Hunter News in which you name foreign firms under IRS investigation. We can appreciate your participating and your committee's interest in this subject.

I want to note, though, for the record that this subcommittee does not release information about specific taxpayers or use names in public. The IRS and this committee are subject to the same disclosure rules. We have not used any names. As I understand it, the names you have listed here are firms that have been publicly disclosed as having been under investigation and are a matter of public record.

Mr. HUNTER. That is right.

Chairman PICKLE. Thank you. We are glad to have you here and Senator Helms.

Mr. HUNTER. I would like to defer to the Senator. I know he has a time problem and I do not.

Chairman PICKLE. We are delighted to have you here Senator Helms. Thank you for your interest.

STATEMENT OF HON. JESSE HELMS, A U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator HELMS. Mr. Chairman and members of the committee, I presided over a lot of committee meetings in the 18 years I have been on the Senate side, I noticed that every witness says "I shall be brief." I remember one in 1978 who was. I don't remember any others.

Let me thank you for the cooperation your staff has given us in working on this matter. I want to compliment this distinguished Congressman, Mr. Hunter, for the work he has done. Let me summarize and if I may ask unanimous consent, Mr. Chairman, that my full statement be used in the record, and I will take just a few minutes.

Chairman PICKLE. Certainly.

Senator HELMS. In April the distinguished House majority leader and I received copies of a letter from Maurice Kupritz of Livingston, N.J. Mr. Kupritz stated that until recently he had been an official of Sony America. He alleged that Sony America was "cheating on taxes, import tariffs and compliance with U.S. laws." These are serious allegations.

Specifically, Mr. Kupritz alleged that Sony America was improperly manipulating accounts between itself and its parent, Sony, Tokyo, so that the company's liability for federal income taxes was improperly reduced.

As an example, he alleged that in 1988 Sony America reported billions of dollars in revenues from its American operations "and profits of only around $10 million."

It is not my intention to single out Sony. But I am satisfied that Mr. Kupritz' estimate of Sony America's reported income are essentially correct. A Sony America official told the staff of the Foreign Relations Committee that Sony America reported between $10 million and $11 million in profits on billions of dollars in sales for the year ending March 31, 1989. Sony paid a minimal tax on this income compared to the size of its operations. Nor was this a one-time phenomenon. Sony reported about the same amount of income in the previous 2 years.

Mr. Chairman, I am not in a position to judge the validity of Mr. Kupritz' other allegations. Sony denies his charges but has declined to furnish the correct figures. I have turned the Kupritz letter over to the investigators for the Internal Revenue Service, the Customs Service, the General Accounting Office and this subcommittee.

I have, however, examined Sony's filings with the Securities and Exchange Commission. There is a chart here the committee members may be interested in. As you can see, in the fiscal year ending March 31, 1990, Sony reported that it earned $1 of sales in Japan for every $2 of sales overseas, including the United States.

These ratios are reversed for reported income and taxes paid. That is, Sony claims to earn twice as much income in Japan as it does overseas. For Sony to be able to do this, either its profit margins are four times in Japan what they are overseas or the company's overseas income is somehow being ascribed to the parent's account. If it is the former, than the Japanese consumer is paying a premium for Sony products.

Whether Sony America is paying a minimal tax because it is shifting income to its parent corporation or whether Sony America has found some legitimate tax shelter, it does not appear to be paying a fair share of taxes to support the American Government. This means American citizens are making up the difference.

On Tuesday, Mr. Charles Triplett of the Internal Revenue Service told the subcommittee that he has studied the tax return data of the foreign subsidiaries of U.S. parent companies operating abroad. Quoting from his testimony at page 13, he said that U.S. firms "generally earned an 8 to 10 percent pretax net operating profit on their business receipts."

So we are contrasting an 8 to 10 percent return for U.S. firms operating abroad against a claimed return by foreign firms operating here of less than 1 percent and, in the case of Japanese firms, of one-tenth of 1 percent. At that rate of return we have to wonder why foreigners would invest here.

By contrast, during 1987, 3-month and 6-month Treasury bills averaged 6 percent.

In fact, 1987 was a relatively good year for foreign companies. The year before they had claimed losses totaling more than $1.5 billion.

What is going on here? Why would any sane businessperson put his or her money in an uninsured business with a return rate of less than 1 percent when he or she could have had 6 percent backed by the full faith and credit of the United States?

The circumstantial evidence suggests that a substantial proportion of the foreign companies operating in the United States are massively underreporting on their Federal income tax. Without doubt, this underreporting has gone on for years, which means that tens of billions of dollars have been lost in taxes to the United States. Does this not amount to a gigantic fraud on the American taxpayers who have had to make up the difference?

Now let me direct the subcommittee's attention to another chart. It shows the U.S. trade imbalance and the increases in U.S. assets of and receipts by foreign firms operating in the United States over the period 1981 through 1987. As you will note, the trade deficit increased by almost 400 percent, 394 percent, U.S. assets held by foreigners were up 150 percent and receipts up 85 percent.

Reported income—called income—less deficit—by the IRS was essentially nowhere, up a mere 5 percent. The increase in the trade deficit looks like an F-16 taking off and the foreigners' U.S. income figure is so small you can barely find it.

But most shocking of all is the fact that foreign companies showing the most success in the United States during the 1980s,—the Japanese,—reported a steady decrease in their income in the United States: in 1984—$1.8 billion; in 1985—$1.3 billion; in 1986—$629 million and in 1987—$219 million. Under these circumstances, if accurate, the Japanese surely would have pulled out of the U.S. market instead of increasing their presence here.

Let me say at this point that I do not believe that the Japanese companies are the only ones at fault. Far from it. At least one South Korean firm is in Tax Court today. However, the Japanese firms are in those lines of businesses, such as manufacturing, where Federal investigators have found a potential for abuse.

Mr. Chairman, you and the ranking member, Mr. Schulze, as well as all the members of this subcommittee, I congratulate you and your staff for the superb job you have done. You have done yeoman work. These hearings have concentrated on certain industries and wholesaling. The Commissioner pointed out in attachment 7 of his testimony the differential of what foreign firms are reporting in the finance and insurance area is far greater than in manufacturing. An appropriate investigation should be made of banking, insurance, construction, securities, and trading companies among other services.

Let me thank you again, Mr. Chairman, for the privilege of being here. I echo and emphasize exactly what so many of you have said this morning and what Duncan Hunter has said that nobody should give any thought whatsoever to raising taxes until we collect the taxes that are already due. I commend you for the work that you are doing. I hope you will forgive me if I slip out and go to the Senate side.

[The prepared statement follows:]

UNITED STATES SENATE

STATEMENT

July 12,1990

SENATOR JESSE HELMS OF NORTH CAROLINA

Testimony before the Oversight Subcommittee
Foreign companies and evasion of income taxes

Mr. Chairman, I thank you and the Subcommittee for the opportunity to testify this morning on the subject of taxation of foreign corporations in the United States.

In April of this year the distinguished House Majority Leader and I received copies of a letter from Mr. Maurice Kupritz of Livingston, New Jersey. Mr. Kupritz stated that until recently he had been an official of Sony America. He alleged that Sony America was "cheating on taxes, import tariffs and compliance with U. S. laws." These are serious allegations.

Specifically, Mr. Kupritz alleged that Sony America was improperly manipulating accounts between itself and its parent, Sony, Tokyo, so that the company's liability for federal income taxes was improperly reduced.

As an example, he alleged that in 1988 Sony America reported billions of dollars in revenues from its American operations "and profits of only around $10 million."

It is not my intention to single out Sony. But I am satisfied that Mr. Kupritz' estimates of Sony America's reported income are essentially correct. A Sony America official told the staff of the Foreign Relations Committee that Sony America reported between $10 million and $11 million in profits on billions of dollars in sales for the year ending March 31, 1989. Sony paid a minimal tax on this income compared to the size of its operations. Nor was this a one-time phenomenon. Sony reported about the same amount of income in the previous two years.

Mr. Chairman, I am not in a position to judge the validity of Mr. Kupritz other allegations. Sony denies his charges but has declined to furnish the correct figures. I have turned the Kupritz letter over to investigators for the Internal Revenue Service, the Customs Service, the General Accounting Office and this Subcommittee.

I have, however, examined Sony's filings with the Securities and Exchange Commission. As you can see, in the fiscal year ending March 31, 1990, Sony reported that it earned one dollar of sales in Japan for every two dollars of sales overseas, including the United States.

These ratios are reversed for reported income and taxes paid. That is, Sony claims to earn twice as much income in Japan as it does overseas. For Sony to be able to do this, either its profit margins are four times in Japan what they are overseas or the company's overseas income is somehow being ascribed to the parent's account. If it is the former, then the Japanese consumer is paying a premium for Sony products.

Whether Sony America is paying a minimal tax because it is shifting income to its parent corporation or whether Sony America has found some legitimate tax shelter, it does not appear to be paying a fair share of taxes to support the American Government. This means American citizens are making up the difference.

Moving beyond Sony to consider the problem in general, the subcommittee has already seen some of the data I am about to present but perhaps not in this form. This chart shows Statistics of

Income data for 1987, the most recent year available, both for all foreign companies operating in the United States and for all Japanese firms. You will note that the reported return on assets and the return on receipts for all Japanese firms is both about one tenth of one percent.

All foreign firms combined were not doing much better -- or so they claimed to the IRS -- reporting a return of considerably less than 1%.

On Tuesday, Mr. Charles Triplett of the Internal Revenue Service told the Subcommittee that he has studied the tax return data of the foreign subsidiaries of U. S. parent companies operating abroad. Quoting from his testimony at page 13, he said that U. S. firms "generally earned an eight to ten percent pre-tax net operating profit on their business receipts".

So we are contrasting an eight to ten percent return for US firms operating abroad against a claimed return by foreign firms operating here of less than one percent and, in the case of Japanese firms, of one tenth of one percent. At that rate of return we have to wonder why foreigners would invest here.

By contrast, during 1987, three month and six-month Treasury bills averaged 6%.

In fact, 1987 was a relatively good year for foreign companies. The year before they had claimed losses totaling more than $1 1/2 billion dollars.

What is going on here? Why would any sane businessperson put his or her money in an uninsured business with a return rate of less than 1% when he or she could have had 6% backed by the full faith and credit of the United States?

Both the circumstantial and the direct evidence suggest that a substantial proportion of the foreign companies operating in the United States are massively underreporting on their federal income tax. Without doubt, this underreporting has gone on for years, which means that tens of billions of dollars have been lost in taxes to the United States. Does this not amount to a gigantic fraud on the American taxpayers who have had to make up the difference?

Now let me direct the Subcommittee's attention to another chart. It shows the U. S. trade imbalance and the increases in U.S. assets of and receipts by foreign firms operating in the United States over the period 1981 through 1987. As you will note, the trade deficit increased by almost 400% [394%], U.S. assets held by foreigners were up 150% and receipts up 85%.

Reported income -- called "Income (less deficit)" by the IRS was essentially nowhere, up a mere 5%. The increase in the trade deficit looks like an F-16 taking off and the foreigners' U.S. income figure is so small you can barely find it.

But most shocking of all is the fact that foreign companies showing the most success in the United States market during the 1980s, -- the Japanese, -- reported a steady decrease in their income in the United States: in 1984 -- $1.8 billion; in 1985 -- $1.3 billion; in 1986 -- $629 million and in 1987 -- $219 million. Under these circumstances, if accurate, the Japanese surely would have pulled out of the U.S. market instead of increasing their presence here.

Let me say at this point that I do not believe that the Japanese companies are the only ones at fault. Far from it. At least one South Korean firm is in Tax Court today. However, the Japanese firms are in those lines of business (such as manufacturing) where Federal investigators have found a potential for abuse.

For example, Yamaha, the Japanese motorcycle maker, is in court fighting an IRS claim of around $150 million and I wouldn't be surprised if other Japanese motorcycle makers have similar problems.

Last month [June 16] the Japanese newspapers reported that the IRS has demanded an additional $330 million in taxes due from Toshiba, Hitachi and Panasonic [Matsushita]. Sony and Mitsubishi have also been mentioned in the Japanese press as providing information to the IRS. Lately, attention has turned to foreign banks operating in the U. S. and several of the major Japanese banks have indicated they are under investigation.

Let me point out that in the 1970's the Japanese National Tax Agency began just the sort of reexamination of taxes we are talking about here. They took a prominent German bank to court, won a judgement and forced all other foreign banks doing business in Japan to pay additional taxes. So the Japanese seem to be a decade ahead of us in the collection of taxes due from foreign subsidiaries doing business in the country.

How much does this shortfall amount to? In February *The New York Times* reported that the IRS has estimated that as much as $12 billion may be owed, and that may be far too low. In 1987 foreign firms had $687 billion in gross receipts in the United States. If we split the difference of Mr. Charles Triplett's estimate of 8% to 10% pretax return by comparable U. S. firms, foreign subsidiaries operating here should have had pretax income of $62 billion. This in turn should have generated $21 billion at a marginal corporate tax rate of 34%. According to the IRS, foreign companies actually paid $4.5 billion in 1987 leaving an uncollected shortfall of $16.5 billion.

And let me emphasize that's for only one year. When we look at prior years and subsequent years, and add penalties and interest, there is a tremendous amount of money involved here, at least tens of billions of dollars.

The immediate consequence of underpayment of federal income taxes by foreign firms is that the American taxpayer -- individuals and competing American firms -- have had to make up the loss. That is, they have had to shoulder an additional burden of tens of billions of dollars in additional taxes to compensate for this cheating. To the extent that Americans do not pay the complete bill, it simply adds to the federal deficit.

The American economy takes a double shot from this system. First, the money which foreign firms should have paid in taxes originates in the private sector of the U.S. economy and is transferred out of the country to the parent firm overseas. Second, the additional taxes which American individuals and firms have to pay are just that much more which is extracted from the productive private sector of the economy and transferred to government.

Mr. Chairman, probably the largest impact is on the competitiveness of American firms. Certainly if you and I are in the same line of business and you pay taxes and I don't, then I have extra funds available to plow back into my business. I can order that new piece of machinery -- but you can't. I can hire some more salesmen to expand my marketing territory -- but you can't.

When American firms are weakened through unfair competition -- and that is what this is -- then their profits are lower. If their profits decline, their spending on plant and equipment, research and development also decline.

Their ability to pay taxes also declines and the federal deficit grows larger and larger.

In short, it has a severely depressing effect on the American economy and threatens to put it into a downward spiral.

This outlines the problem. The distinguished public and private witnesses which follow me will discuss this in more depth but we need to look at solutions.

Whatever needs to be done to collect the taxes owed by foreign corporations operating in the United States, we have to do it. Those who have not paid their fair share should be made to do so before the American taxpayer is asked for another penny.

Mr. Chairman, in early March I asked the General Accounting Office to undertake a complete investigation of this issue and propose solutions. I am very pleased that the Joint Committee on Taxation joined me in this request. We should have some indication of their thinking in the fall.

In tbe meantime, it is clear that the IRS is not devoting nearly enough resources to this issue. You may have already discussed this with the Commissioner when he testified on Tuesday but one possibility worth exploring is whether the domestic corporate audit division could be asked to share some of the burden of auditing foreign firms. As I understand it, the domestic corporate division received additional auditors when personal taxes were simplified in 1986 and there was a reduced need for auditors there. If the IRS needs to hire outside experts, then let's get them. Whatever it takes to do the job.

There is no question that vigorous prosecution is needed to ensure that foreign corporations who operate here pay their fair share of tax. If there is tax fraud, there should be jail time for those responsible.

I have examined HR 4308, now before the Committee, and its Senate companion, S.2410. They certainly have merit but I have decided not to be a cosponsor because I believe that Title II, relating to the disposition of stock, is extraneous and does not contribute towards resolution of this immediate problem.

Mr. Chairman, you and the Ranking Member, Mr. Schulze, as well as all the Members of this Subcommittee and the staff deserve congratulations for the thorough job you have done. I would note however, that these hearings have concentrated on certain manufacturing industries and wholesaling. As Commissioner Goldberg pointed out in Attachment 7 of his testimony, the differential between what U. S. firms and what foreign firms are reporting in the finance and insurance areas is far greater than in manufacturing. An appropriate investigation should be made of banking, insurance, construction, securities and trading companies, among other services.

In conclusion, I again thank the Subcommittee for the opportunity to testify on this very important subject. If the Subcommittee's work leads to a reduction of the heavy tax burden on the American taxpayers, they will thank the Subcommittee also.

SONY

Year Ending March 31, 1990

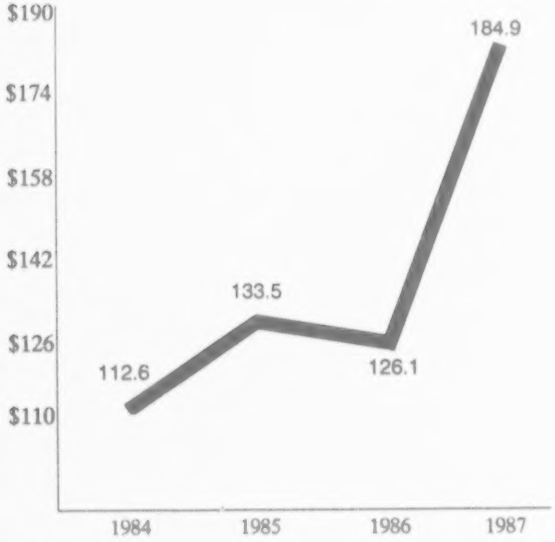
Sales	**%**
Japan	34
Overseas	66
Income Before Taxes	
Japan	62
Overseas	38
Income Taxes - Current	
Japan	71
Overseas	29

Source: Securities and Exchange Commission

Chart: Senate Republican Conference

JAPANESE CONTROLLED U.S. CORPORATIONS RECEIPTS

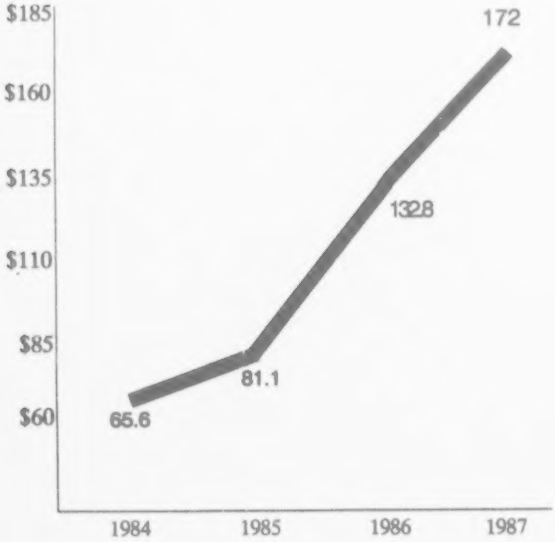
(IN BILLIONS OF DOLLARS)



Source: Department of Treasury

JAPANESE CONTROLLED U.S. CORPORATIONS ASSETS

(IN BILLIONS OF DOLLARS)



Source: Department of Treasury

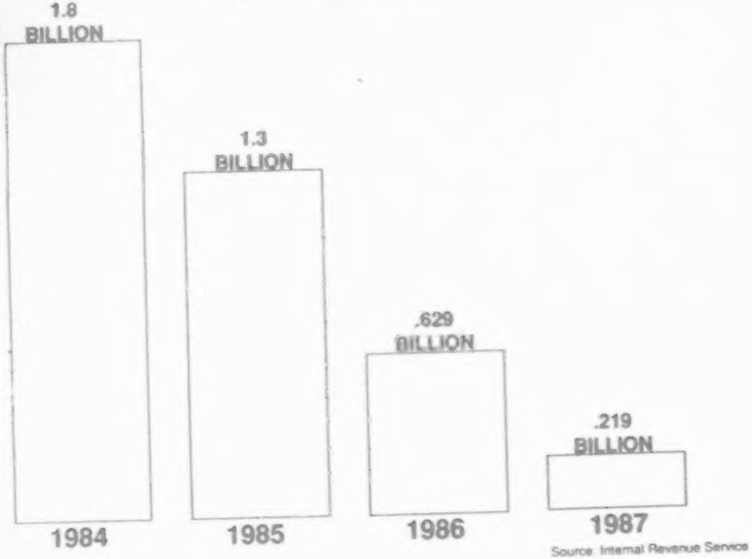
Analysis of SOI Data for Foreign Controlled U.S. Companies

1987

	Total Assets	Total Receipts	Income (Less Deficit)	Return on Assets	Return on Receipts
All Foreign	$959 bil.	687 bil	5.6bil	.58%	.82%
Japanese	$172 bil.	182 bil	219 mil	.137 %	.12%

Source: U.S. Department of the Treasury

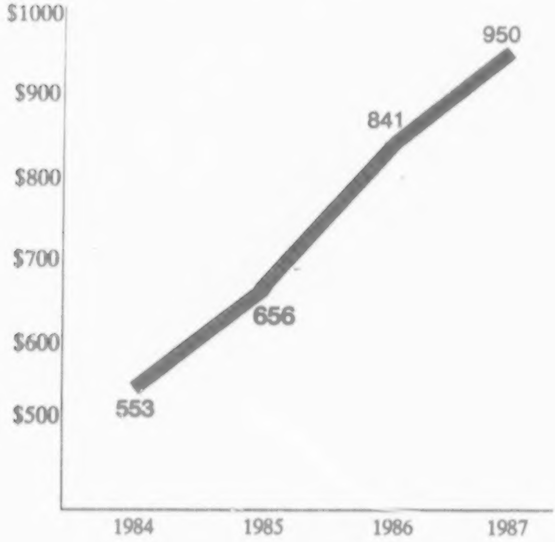
JAPANESE COMPANY NET INCOME (LESS DEFICIT)



Source: Internal Revenue Service

FOREIGN CONTROLLED U.S. CORPORATIONS ASSETS

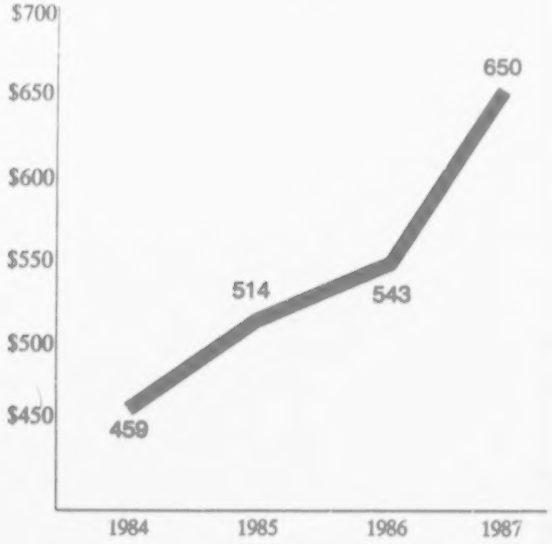
(IN BILLIONS OF DOLLARS)



Source: Department of Treasury

FOREIGN CONTROLLED U.S. CORPORATIONS RECEIPTS

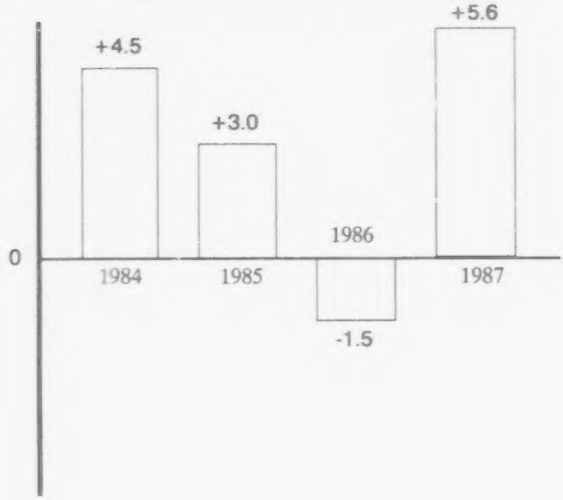
(IN BILLIONS OF DOLLARS)



Source: Department of Treasury

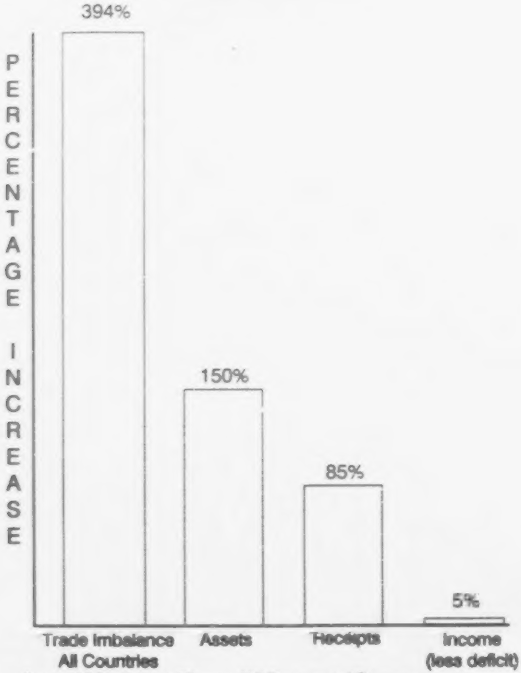
FOREIGN CONTROLLED U.S.
CORPORATIONS
NET INCOME (LESS DEFICIT)

(IN BILLIONS OF DOLLARS)



Source: Department of the Treasury

FOREIGN CONTROLLED U.S.
CORPORATIONS
1981-1987



Source: U.S. Department of Treasury, U.S. Department of Commerce

1987 TAX YEAR

Foreign Company Receipts	$687 Billion
Expected Rate of Return	9%
Expected Income	$ 62 Billion
Corporate Tax Rate	34%
Anticipated Tax	$ 21 Billion
Actual Tax Paid	$ 4.5 Billion
Shortfall	$ 16.5 Billion

FOREIGN CONTROLLED U.S. CORPORATIONS

1981-1987

Total Receipts - 7,327 Billion

Total Income (less deficit) - 20 Billion

Return on Receipts - 0.27%

Source: U.S. Department of Treasury

Chairman PICKLE. Senator, we appreciate your testimony and your interest because it adds a great deal to the concentration that the Congress should give. We have bipartisan support. Your participation is meaningful to this committee and I want to thank you.

Before I go into questions, Mr. Hunter we have a vote and I know you would want to be recorded. We have some members coming back but since you are going to vote, I think I will declare a 10-minute recess so we can go and be back before that time.

Senator Helms, we will excuse you if you wish.

Senator HELMS. We have a unanimous consent motion on the floor. In fairness to Sony Corp. I did receive a letter belatedly from the chief executive officer from Sony Corp., I would like to have that made a part of the record as well.

[The letter from Sony Corp. follows:]

Sony Corporation of America
Sony Drive
Park Ridge, New Jersey 07656
Telephone (201) 930-6100

N. Vander Dussen
President
Chief Operating Officer

July 6, 1990

The Honorable Jesse A. Helms
United States Senate
403 Senate Dirksen Office Building
Washington, D.C. 20510-3301

Dear Senator Helms:

Mr. Akio Morita asked me to respond to your June 27 letter concerning correspondence that you received from Mr. Maurice Kupritz. In his letter, Mr. Kupritz accused our Company of failing to comply with the laws of the United States. You asked for our response. I have also read your Senate floor statement of June 28, which reiterated that request. I shall address each of your questions in turn, however, I regret that we did not have an opportunity to respond to your letter before your June 28 statement.

1. "Was Mr. Kupritz an employee of Sony America and did he hold the position that he indicated?"

Response: Mr. Kupritz was briefly employed for ten months by Sony Corporation of America, from August 29, 1988 to June 30, 1989. Contrary to his claims, however, Mr. Kupritz was not Director of "Government Compliance". He was a mid-level manager with responsibility for supervising routine portions of our import and export activities through a network of independent customs brokers and freight forwarders. His job did not encompass taxation or accounting matters.

Contrary to his claims, Mr. Kupritz was not terminated on "trumped-up charges". He was terminated as a result of an investigation conducted pursuant to our Company's policy against sexual harassment after a female subordinate of Mr. Kupritz lodged what proved to be a well-founded complaint against him for violations of that policy. On May 14, 1990 the complainant filed a civil lawsuit against Mr. Kupritz alleging battery, personal injury, and sexual harassment, among other things. I hasten to add that Sony played no role in the initiation of this lawsuit.

Several months after his termination, and after we denied his demands for reinstatement, Mr. Kupritz filed a civil lawsuit against Sony for wrongful termination, including various other charges, among them violation of constitutional rights, libel, and slander. This litigation is still pending. Thereafter, Mr. Kupritz also filed an age discrimination charge against Sony with the State of New Jersey. That charge is also pending. Further, it is my understanding that Mr. Kupritz has filed an unrelated legal action against another former employer, Bristol-Myers.

2. "Is it true that Sony America reported 'revenues of $8 billion and profits of only around $10 million (for 1988)?' If this is not true, would you supply me with the correct figures?"

Response: The amount of revenues and profits stated by Mr. Kupritz in his letter are erroneous. As to the correct amount of revenues and profits, Sony Corporation of America has made full and accurate reports to the Internal Revenue Service and other governmental agencies as required by law.

3. "What is the procedure that Sony America uses to report account information to its parent firm?"

Response: Sony Corporation of America reports account information in accordance with standard accounting practices. In his letter, Mr. Kupritz makes a vague reference to what he terms "service charges" running between Sony America and Sony Tokyo. Although we can only speculate as to what he means by this claim, we believe that Mr. Kupritz was referring to numerous inter-company agreements between Sony Tokyo and Sony America by which Sony Tokyo, in the vast majority of cases, reimburses Sony America for certain specific expenses. In some cases, Sony America pays Sony Tokyo reasonable fees related to our use of patents, trademarks and know-how in our extensive U.S. manufacturing operations. There is nothing nefarious or underhanded about these agreements, which have been given to the Internal Revenue Service in connection with their routine examinations of Sony Corporation of America's federal tax returns. Mr. Kupritz' suspicions can only have been caused by his lack of familiarity with such transactions.

4. "Is there any validity to the charges leveled in the Kupritz letter?"

Response: No. Mr. Kupritz' letter makes a number of reckless charges concerning this Company. Not one of these charges is true. His false claims respecting this Company's alleged non-compliance with U.S. tax laws are particularly troubling. Like many other U.S. companies, Sony Corporation of America's annual federal tax returns are carefully examined by the Internal Revenue Service on a routine basis.

In addition, Mr. Kupritz made what we have determined to be a spurious charge that he was instructed to destroy a memorandum critical of the Company. We believe the memo he refers to was actually written to in-house counsel and was very general in nature, e.g., Mr. Kupritz began by saying, "The purpose of this memo is to ensure that SONAM is in compliance with Section 1059A of the 1986 Tax Code". More importantly, the memo contained not a single mention of any particular problem, shortcoming, or element of wrong-doing. Finally, when questioned by our counsel upon receipt of the memo, Mr. Kupritz was not able to identify any particular problem which he wished to raise.

We appreciate this opportunity to respond to Mr. Kupritz' charges. Sony has consistently strived to build a reputation for quality, both in our products and in our business conduct. We have a 30 year history of significant investment in the United States. We employ approximately 15,000 Americans in our electronics, records, and motion picture operations. Thus, we have a vested interest in seeing a financially sound U.S. economy and would never shirk responsibility for our fair share of the tax burden.

Moreover, we are continually investing in our U.S. facilities, such as a recently completed addition to our San Diego plant of a 32" color television production line. This addition involved capital expenditures in excess of $100 million. In every country in which we operate, we strive not only to be successful in business, but to be a good corporate citizen as well, including full compliance with all applicable laws and regulations. Given these facts, Mr. Kupritz' charges are particularly repugnant.

I am pleased to have had this opportunity to respond to your concerns.

Very truly yours,

N. Vander Dussen

N. Vander Dussen
President and
Chief Operating Officer

NVD:gmd

Chairman PICKLE. Thank you again. We appreciate your forbearance in our lengthy hearing. Thank you.

The committee will stand adjourned for approximately 10 minutes.

[Recess.]

Chairman PICKLE. Congressman Hunter, we are pleased to have you here today. Again, we express our regret that these hearing have been prolonged but we think they are extremely important to our country. We are very appreciative of the interest you and your committee have shown in this same subject.

We certainly appreciate having you here. You are recognized.

STATEMENT OF HON. DUNCAN HUNTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. HUNTER. Thank you very much. Mr. Schulze, Mr. McGrath, thank you for letting me be here to testify about this very important issue. A lot of people have spoken. You have heard a great deal of testimony from the relevant agencies. First, Mr. Chairman, let me apologize to you on behalf of the Republican Research Committee, which is a part of the Republican leadership, for jumping the gun on this issue, if you will, and for moving ahead on it and with the simple explanation that when it became apparent that the Democratic negotiators in the budget summit had, from my understanding, informed the President that a word about the need for taxes was necessary to continue the summit, and those words were put in and put out with great fanfare. We had been working this issue for 11 months in the House Republican Research Committee.

Those of us who had seen the figures and saw this enormous liability for foreign-owned corporations in taxes felt that it was necessary to point out that this source should be utilized before a single American taxpayer paid a dime in taxes. In fact, that was the import of the letter that I sent to the budget negotiators on behalf of the Republican leadership.

I would ask, Mr. Chairman, that my testimony be included in the record.

Chairman PICKLE. Without objection, it certainly will be.

Mr. HUNTER. I will try to summarize. First I have reviewed the testimony of Tuesday and I want to commend you and our ranking member, Mr. Schulze, and Mr. McGrath and all the members of the subcommittee as well as your staff which had done an excellent job here.

I think this is one of the most thorough and professional investigations that I have seen in the past decade. Let me just speak briefly about what I think we should do. I would like to borrow Senator Helms' charts and I would like to give him some credit, too, because his initial investigations were investigations that uncovered facts that began to move us on our Republican Leadership Committee into this investigation.

I think these best illustrate the problem. The first chart shows the increase in assets of Japanese owned U.S. companies and the second shows the increase in gross receipts by Japanese owned U.S. companies. This is from 1984 to 1987. As you can see, only an F-14 can do a vertical climb of this magnitude. It is clear the Japanese, and as I think the majority leader's statement indicated, are doing a phenomenal business in the United States and they are increasing their holdings here so they can do even more.

The third chart shows their income as reported to the IRS falling like a stone. Every year their reported profits declined. If you work out the mathematics, in 1987, roughly that means that Japanese owned companies doing business in the United States reported for every $100 of income and receipts roughly 1 to 1.5 percent, that is 12 cents of taxable income. Now that is compared to the average American company that is reporting about a 5 to 8 percent taxable income, it is one-fiftieth. That is twelve one-hundredths of 1 percent. That means for every $100 of receipts, the average Japanese company doing business in America says that they have a taxable profit of 12 cents.

If you apply roughly one-third tax to that, that means they will pay 4 pennies of tax for every $100 in receipts. That is why in doing some fairly rough calculations we have come to the conclusion that there is a potential recoverable tax in excess of $50 billion if you cover the entire universe of the foreign-owned corporations doing business in the United States.

I mention foreign-owned corporations in general are paying about eighty-five one-hundredths or eighty-two one-hundredths of 1 percent in taxable income or claiming that as taxable income. So while they are doing much better than the Americans they are still far below the taxable incomes as reported by American corporations. On Tuesday, Mr. McNulty told the subcommittee that what is going on would defy the general rules of supply and demand. I submit what is going on would defy every rule and law in existence including the law of gravity.

No one can argue that this is a fair representation of what was really going on in the American market during that time period. It makes no economic sense at all. It only makes sense to those corporations as a massive fraud on the American Government and the American taxpayer. I think perhaps Mr. Dorgan brought this up or Mr. Gephardt, that this also affects the competitiveness of American corporations which are attempting to sell in the same particular arena as these foreign held corporations.

The existing rules prohibit the release of individual taxpayer information. Frankly, given the size of this fraud, I do not think these rules are appropriate anymore. I think the American people should be made aware of who is paying their fair share and who is imposing on the rest of it.

Particularly when we talk about massive corporations doing business in the United States, running multibillion dollar ad campaigns in the United States, I think it is important for American taxpayers to be able to know that the particular corporation which is selling them, oh what a feeling, or buy my product or this is the best VCR in the world, that those corporations are not contributing to the infrastructure in which this country operates, they are not building highways. They are not contributing to the educational foundation which allows people who have to earn the kinds of dollars that they need to buy those foreign products.

They are not contributing to the medical programs, the medical system of the United States. I think that is important information that the American people need to have. Because of that, I think some rules on disclosure and the changing of some rules on disclosure would be appropriate here.

I can show you what is public, Mr. Chairman, you mentioned that we cannot show information which is classified in the sense of being known to the IRS and the committee, but I can show you what is public. This chart shows a list of those Japanese firms which the Japanese and American press have identified as being under investigation by the IRS.

This is a list of banks, car companies, motorcycle companies, TV makers, computer makers, metals, et cetera. There are a lot of famous names, Toshiba, Toyota, Sony, Sumitomo, Mitsubishi, Matsushita, which we know as Panasonic. According to the Reuters they are looking at 11 different subsidiaries of Hitachi. The list that ought to be under investigation is much larger but those names which have not been made public cannot be shown here and would fill, I can assure, several more charts.

On Tuesday, the subcommittee heard from field agents and staff. If the testimony could be boiled down it would be a need for more resources. The staff reported the IRS is currently outgunned. I want to give my commendation. I believe Representative Frank Wolf offered an amendment in appropriations which is going to result in several millions more dollars being available for enforcement.

I think these proposals certainly have merit. I will leave them to the expertise of this committee to evaluate. At the same time, I think a new approach is needed to cut through the present barriers and make it possible to collect the tens of billions of dollars due.

First, we have the problem of foreign documentation. It is clear from Tuesday's testimony that foreign firms are seriously impeding the process by failing to provide documentation. You will recall the reference to 40 boxes of documents which were submitted with no index. I believe that the so-called fourth methods approach should be expanded to include a best available information rule.

If the parent is uncooperative, the IRS should be able to make a determination based on the best information available, maybe an industry average on profits. If the taxpayer is uncooperative and claims a series of losses but no documentation in English to back it up, the IRS should be able to use Mr. Triplett's estimated return of 8 to 12 percent for comparable American firms.

This is not unprecedented. I direct the subcommittee's attention to the Code of Regulations 353.37 which allows the Secretary of Commerce to use the best information available in dumping cases when faced with a recalcitrant party.

Second, we need to fast track the judicial process. The testimony Tuesday indicated that it takes years to successfully prosecute one of these cases. In the meantime, the majority of IRS personnel may have turned over due to attrition and if the foreign parent knew the case had priority both within the IRS and in the course its attention would be properly focused on settlement, the settlements that come about only come about because the moment of truth is approached on the calendar just like in a court case where you have a civil case generally speaking the attorneys don't get together from the defendant's standpoint and start making serious offers of settlement until the trial date approaches.

I asked from some figures that would show us the time frame in which IRS audits of foreign-owned corporations are completed, just the audit, not the court actions. Some of these companies are analogous death row defendants, they are on death row forever and it is a long time between the incursion of the liability and the actual deposit of unpaid taxes in the U.S. Treasury.

Automobile manufacturers, time frame for IRS audits is now 10 years, that is an historical average. Electronics and motorcycles, between 4 and 5 years. The timeframe for IRS audits of U.S. corporations in the average according to my information is about 30 months.

Let me put this in perspective. If we have corporations that owe potentially billions of dollars to the U.S. Treasury and our budget constraints make that a matter which is so urgent that we have a budget summit to attempt to derive some way to bring in more revenue, if you have a multibillion dollar case pending that we could give prioritization to and it is help up because you have other tax cases on the calendar, for example, tax cases against American individuals or firms that amount to perhaps hundreds of thousands or tens of thousands of dollars, it makes a lot of sense to go top these cases in which a potential big dollar recovery is available.

If we can bring in these billions of dollars, we are going to have relief in our budgetary process. Because of that, I think we ought to have some type of legislation that gives a fast track to the investigation and prosecution of foreign-owned corporations which have not been paying their fair share of taxes.

Mr. DORGAN [presiding]. Mr. Hunter, could you summarize for us?

Mr. HUNTER. Yes, sir. I will offer the entire statement for the record.

Mr. DORGAN. Without objection.

Mr. HUNTER. What I think we need to do is have a fast track system that will allow us to get to audit and through audit quickly and a prioritization on court calendars that will allow actual judgments to come down in short order.

I strongly endorse this idea of having a strike force developed within the IRS to target these abuses to once again bring the investigation and court action to a head.

I think that the budgeteers, again the Republican leadership has written a letter to the budgeteers saying we do not want to see a penny of new taxes levied on the American people unless there is a full accounting and full payment of taxes owed by foreign-owned corporations.

I think we should make this part of the budget process. I think your committee would be the appropriate body to move that to the budgeteers.

[The statement and attachment of Representative Hunter follow. Also, the tables referred to by Representative Hunter follow the Sony chart attached to Senator Helms statement beginning on page 280.]

July 12, 1990

STATEMENT OF REP. DUNCAN HUNTER REPUBLICAN OF CALIFORNIA

Testimony before the Oversight Committee Tax Evasion by Foreign Firms

Mr. Chairman and members of the Subcommittee, good afternoon.

Almost eleven months ago Senator Jesse Helms, whom you have just heard, brought to my attention the question of tax cheating by foreign firms operating in the United States. After some discussion we concluded that the issue would be best left to the Committee of competent jurisdiction. At the same time, however, as Chairman of the House Republican Research Committee I encouraged the creation of a task force under Rep. Tom Campbell of California to develop an understanding of this complex area of the tax law.

Mr. Chairman, I have reviewed the testimony of Tuesday and I commend you, the Ranking Member and the other Members of the Sucommittee as well as the Subcommittee staff for a job well done. Clearly this is one of the most thorough and professional investigations I have seen in the past decade.

My comments will be brief.

1. The Problem

I would like to borrow Senator Helms' charts because I think they best illustrate the problem before us. The first chart shows the increase in assets of Japanese-owned U. S. companies and the second shows the increase in gross receipts by Japanese-owned U. S. companies. This is for the middle 80's 1984-1987. Only in an F-14 do you see a vertical climb of this magnitude. It is clear that the Japanese were doing phenomenal business in the United States and increasing their holdings here so they could do even more.

The third chart shows their income, as reported to the IRS, falling like a stone. Every year their reported profits declined.

On Tuesday Mr. Neil McNulty, one of the IRS managers told the Subcommittee that what is going on here would "defy the general rules of supply and demand".

I would submit that in fact what is going on here would defy every rule and law in existence including the law of gravity.

No one can argue that this is a fair representation of what was really going on in the American market during that time period. It makes no economic sense at all.

It only makes sense as a massive fraud on the American government and the American taxpayer.

2. Naming Names

The existing rules prohibit the release of individual taxpayer information. Frankly, given the size of this fraud, I do not think these rules are appropriate anymore. I think the American people should be made aware of who is paying their fair share and who is imposing on the rest of us. Who is a good neighbor and who is not. But until these rules are changed, I am bound to obey them.

I can, however, show what is public. This chart shows the list of those Japanese firms which the Japanese and American press have identified as being under investigation by the IRS. This is the list - banks, car companies, motorcycle companies, TV makers, computer makers, metals, and so forth. There are a lot of famous names - Toshiba and Toyota, Sony and Sumitomo, Mitsubishi and Matsushita, which we know as Panasonic. According to Reuters they are looking at eleven different subsidiaries of Hitachi, which may be a new record.

The list of those who are under investigation or ought to be under investigation but whose names have not been made public would fill several more charts.

3. Solutions

On Tuesday the Subcommittee heard from field agents and from Subcommittee staff. If the testimony could be boiled down, it would be a need for more resources. As the staff report indicated, the IRS is currently "outgunned". These proposals certainly have merit and but I will leave them to the expertise of this committee to evaluate.

At the same time I believe a new approach is needed, one which will cut through the present barriers and make it possible to collect the tens of billions of dollars which are due.

First, we have to deal with the problem of foreign documentation. It is clear from Tuesday's testimony that foreign firms are seriously impeding the process by failing to provide documentation. You will recall the reference to forty boxes of documents with no index.

I believe that the so-called "fourth methods" approach to valuation should be expanded to include a "best available information" rule. That is, if the foreign parent is uncooperative, the IRS should be able to make a tax determination based on the best available information to it.

For example, if the taxpayer is uncooperative and claims a series of losses but no documentation, in English, to back it up, the IRS should be able to use Mr. Charles Triplett's estimated return of 8-10% for comparable American firms.

This is not unprecedented. I would direct the Subcommittee's attention to the Code of Federal Regulations Section 353.37 which allows the Secretary of Commerce to use the best information available in dumping caes when he is faced with a recalcitrant party.

Second, we need to fast track the judicial process. The testimony on Tuesday indicated that it takes years and years to successfully prosecute one of these cases. In the meantime, the majority of the IRS personnel working on the cases have turned over due to personnel rotation and attrition. If the foreign parent knew that an "inbound" case had priority both within the IRS and in the courts, its attention would be properly focused on settlement.

4. Criminal Prosecution

American citizens who conspire to defraud the government of large amounts of tax money stand a good chance of going to jail. The same should be true of any foreigner who takes advantage of our open market but defrauds the American government of tax money. This should also include those who aid and abet this fraud as attorneys or advisors.

Again this is not unprecedented. In September 1978 the Federal Grand Jury for the Central District of California indicted an American retailer and accused it and other individual and corporate unindicted co-conspirators of having "knowingly and willfully conspire(d) together and with each other to defraud the United States of America" by evading duties on imported television sets. Some of those named were Japanese officials of Toshiba and Sanyo and others were attorneys or employees of the retailer.

Do the facts warrant criminal prosecution? I would direct the Subcommittee's attention to pages 10 and 11 of the staff report: "The companies talk to one another keeping each appraised of IRS audit techniques and issues raised. According to the IRS, if one company begins to take advantage of a tax issue, the entire industry begins to do likewise". I would also direct your attention to the widespread reports on Tuesday of customs fraud, double billing of insurance, non-existent negotiations between parent and subsidiary and so forth.

At the very least these facts indicate there are sufficient indications of collusion and conspiracy to warrant an investigation.

5. The Future

The investigation of this Subcommittee, however excellent, has had to have a focus. That focus has been manufacturing and wholesaling in the automobile, motorcycle and electronics areas.

However, there is another entire area which needs consideration and that is services - banking, insurance, construction, securities and trading firms. Just as this Subcommittee has determined that some wholesalers have paid no taxes for years, likewise the *New York Times* on June 18, 1990 revealed that some foreign banks have shown no taxable income. As the Commissioner noted in Appendix 7 of his testimony, the banking and insurance categories reported negative income between 1983-87 and the same time that American firms were returning 5.7% on receipts.

Finally, Mr. Chairman, let me commend you and the Subcommittee again for holding these important hearings.

JAPANESE FIRMS UNDER

INVESTIGATION BY THE IRS

Daiichi Kango Bank [Asahi June 24, 1990]

Fuji Bank [Asahi June 24, 1990]

Fujitsu [Japan Economic Journal June 29, 1990]

Hitachi USA [Japan Economic Journal June 23, 1990]

Hitachi Chemical (USA) [Japan Economic Journal June 23, 1990]

Hitachi Metals (USA) [Japan Economic Journal June 23, 1990]

Matsushita Electric Corp of America (Panasonic) [Japan Economic Journal June 23, 1990]

Mitsubishi Electric (USA) [Jiji Press, June 15, 1990]

NEC [Japan Economic Journal June 29, 1990]

Nissan [Wall Street Journal December 4, 1987]

Nissei Sangyo [Japan Economic Journal June 23, 1990]

Sony America [Japan Economic Journal July 7, 1990]

Sumitomo Bank [Asahi June 24, 1990]

Tokai Bank [New York Times June 18, 1990]

Toshiba America [Japan Economic Journal June 23, 1990]

Toyota USA [Wall Street Journal December 4, 1987]

Yamaha USA [New York Times January 18, 1990]

Mr. DORGAN. Your testimony is very interesting and useful. You have obviously done a lot of work to understand this area. It is a very complicated area, and the committee wants to thank you for your presentation. I certainly share most of your concerns and your feelings.

I think many members of the committee do, as well. I would like to make one comment about the issue of confidentiality. The confidentiality of tax information is absolutely critical to the integrity of the tax system.

Mr. DORGAN. And I do not share your suggestion or do not support a suggestion that we in any way impugn the confidentiality provision, change the provisions, or literally alter the principals of confidentiality in our Tax Code.

There are ways, obviously, to get on the record who is not paying taxes, who is underreporting taxes, who is evading and who is avoiding taxes in this country. And I support those methods. In fact, I am concerned that those methods have not been fully employed with respect to foreign corporations doing business through U.S. subsidiaries.

But I would want to be very careful about the question of confidentiality. The names of firms that are on the board came from the press and the press, we know, said that Tom Dewey was President. Tom understood he wasn't. I guess the press didn't understand that.

The press makes mistakes, and it would be unfortunate if the name of a corporation that was conscientious and did pay taxes was out there as a corporation that was shirking their responsibility.

Let me make one final point. While I think it's important in those instances to protect those taxpayers fully, I think the main thrust of your testimony is right on the mark.

My own belief, looking at the data, is that there's systematic, substantial tax avoidance in a routine way. It's cheating this country out of billions of dollars of needed revenue. It puts American producers at a serious competitive disadvantage, doing business in competition with others who do not pay their fair share.

We need to get to the bottom of it. We need to make whatever changes are necessary to be able to deal with this problem. And having been a tax administrator on the other side of the table from some very sophisticated corporations that have almost unlimited resources with which to fight, I understand the difficulty and the complexity that the Internal Revenue Service faces in these cases.

We need to give the IRS the tools necessary to solve this problem and to demand that it be solved very quickly.

Mr. McGrath will inquire.

Mr. McGRATH. Thank you, Mr. Dorgan

I couldn't have said it better. I don't want to hold my colleague up. I know he is a busy man these days, but I do want to thank him for the indepth analysis that he has provided for the committee. We certainly know the work that has gone into it.

I want to compliment him on bringing to the attention of the committee some time back what we feel now to be a most egregious act, and we thank him for his testimony today.

Thank you.

Mr. HUNTER. I thank my friend, and Mr. Chairman, one point of confidentiality, if I could.

As I understand it, not only, I can understand investigations being confidential because they may not be found in the end to be valid.

But as I understand it also, many times when liability is found, for example, I think when—in the Toyota case, I believe they paid an undisclosed amount of taxes, which to the American consumer who is buying their products by the billions of dollars worth, maybe at $1 or maybe $5 billion.

And once the case has been resolved by settlement or by court, I think allowing the American consumers to know the contribution of their, of companies which they are patronizing to the American system, the medical system, the infrastructure, et cetera, is an appropriate thing for people to be informed of that information.

Is that something that could be brought about? That is after the fact, showing tax liability for companies that have been found to have violated the tax laws, or made a settlement in that respect.

Mr. Dorgan. Well, it's something certainly that will be discussed, I am sure. You may be familiar, that some localities require when somebody hasn't paid their real estate taxes, it's posted at the post office or in the newspapers.

We don't do that at the Federal income tax levels. We are also talking about $1 trillion worth of business is estimated be done in this country by foreign corporations through U.S. subsidiaries.

The estimate is they will pay, if they paid what they have paid in the past, about $5 billion worth of taxes, when in fact if they paid what American corporations paid, they would pay over $30 billion in taxes.

Mr. Hunter. Precisely.

Mr. Dorgan. We are talking about the potential of $25 billion of tax avoidance by foreign corporations. Again, let me commend you on the work that you have brought to the committee and thank you very much for your appearance here today.

Mr. Hunter. Thank you, Mr. Chairman.

Mr. Dorgan. Next the committee will hear from the U.S. Department of Commerce represented by the Deputy Assistant Secretary for Trade Information Analysis, Barbara McLennan; and the Deputy Assistant Secretary for Investigations, International Trade Administration, Frank Sailer.

If they are here, would they please step forward and take their seats at the table.

The committee would ask Barbara McLennan and Frank Sailer to please summarize your testimony. A copy of your entire testimony will be made a permanent part of the record, and we will begin with Barbara McLennan, the Deputy Assistant Secretary for Trade Information.

Ms. McLennan. That is mine, Mr. Chairman, thank you.

It's a pleasure for me to appear before the subcommittee——

Mr. Dorgan. The Chair would like order in the chamber, please.

The Chair would ask members of the audience to please take seats. Thank you.

You may proceed.

STATEMENT OF BARBARA N. McLENNAN, DEPUTY ASSISTANT SECRETARY FOR TRADE INFORMATION AND ANALYSIS, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Ms. McLennan. Thank you, Mr. Chairman.

It's a pleasure for me to appear before this subcommittee to discuss the Commerce Department's concerns relating to possible transfer pricing abuse by foreign corporations with U.S. affiliates. This is an issue that has received considerable attention lately, both within Congress and the executive branch, and has potentially serious implications for the Federal budget deficit, for the U.S. trade balance, and for the international competitiveness of U.S. industry.

The impact of transfer pricing on Federal tax revenue is quite properly the primary concern of Treasury and the Internal Revenue Service. Commerce has no particular expertise to bring to bear on this question.

However, transfer pricing practices can affect the current account and overall balance of payment deficits via their effect on Federal budget deficits, and those are of interest to Commerce, particularly the International Trade Administration.

In addition to indirectly affecting the trade balance via the budget deficit, transfer pricing abuses can potentially exert direct effects on the U.S. balance of trade.

For example, if a foreign owned multinational company establishes transfer prices with its U.S. affiliate that are not at arm's-length, so that a disproportionate share of combined company income is allocated to the parent, the U.S. balance of trade, other things equal, will worsen.

In this situation, the parent will sell to the U.S. affiliate at prices that are artificially high, resulting in an inflation of imports. At the same time, it will compensate the affiliate for value received at less than arm's-length price prices, reducing the value of U.S. exports.

The result is to increase the trade deficit or reduce the surplus above or below what it otherwise would be. Such transfer pricing practices can have a significant impact on the country's balance of payments when a large portion of its trade consists of intracompany transactions.

In principle, not all transfer pricing abuse need have a negative effect on the balance of payments. Suppose, for example, a foreign company lowers the prices it charges to its wholly owned U.S.-based distributor in order to increase the market share for its goods in the American market.

It's possible that in this case, the value of U.S. imports from this country will decrease. For such a result to occur, it would be necessary for the domestic demand for the goods to be relatively insensitive to price changes, or the increased purchase of goods from the foreign company in question is largely at the expense of higher priced foreign suppliers, rather than from domestic producers.

If either or both of these conditions is met, newly introduced transfer pricing abuses may, but are not likely, to actually improve the U.S. balance of payments.

The two examples of transfer pricing irregularities described above suggest two conflicting motives that foreign firms may have for engaging in such practices.

The first, and the one that is the major focus of this hearing, is to shift corporate tax liabilities from the United States to the home country.

The second motive, and of a primary concern to Commerce, is to gain a competitive advantage over domestically controlled firms in either or both the United States or foreign markets by using aggressive transfer pricing to in effect subsidize the U.S. affiliates.

The use of abusive transfer pricing by foreign firms to enhance their competitive position may or may not worsen the U.S. trade balance in the short run, though it likely will in the long run if foreign firms and their U.S. affiliates succeed in gaining market share internationally.

However, whatever the effect of transfer pricing abuses on the balance of payments, if they adversely affect the ability of U.S. business to compete in international markets, they are of concern to Commerce and to the International Trade Administration, particularly.

The potential for transfer pricing and its abuse has probably increased with the rapid growth of foreign direct investment in the United States, and the increase in the number of U.S. affiliates of foreign owned firms.

Foreign direct investment in the United States increased by over $300 billion in the 1980s. At the end of 1980, the book value of foreign investments was $83 billion. By the end of 1989, it had risen to $401 billion.

Foreign direct investment in the United States grew at an annual average rate of 19 percent from 1980 to 1989, clearly outpacing either the growth in the world economy or of global trade.

At the same time, the growth of U.S. direct investment abroad was slowing down. In 1980, the United States accounted for 43 percent of worldwide outward direct investment and only 16 percent of inward investment.

By 1987, U.S. direct investment abroad was only 32 percent of the world total, while $1 in every $4 of inwardly directed investment flowed into the United States.

The U.S. manufacturing sector has attracted the most foreign direct investment in the United States, accounting for two-fifths of the total in 1989, followed by wholesale and retail trade, with only one-fifth of the total.

Real estate was a distant third accounting for less than one-tenth of the total. Direct investments in both of the first two sectors can potentially give rise to transfer pricing abuses. If transfer pricing abuses exist, they would show up in cross border intracompany trade.

Table 1 in my testimony compiled from 1987 data on foreign direct investment in the United States prepared by the Bureau of Economic Analysis summarizes trade between foreign firms and their U.S. subsidiaries, by industry and country.

What is striking about this data is how much of U.S. international trade, particularly imports, are accounted for by parent-affiliate trade. Of total U.S. exports, the equivalent of 19 percent came from affiliates of foreign corporations in 1987, and 8 percent of these exports went to the foreign parent corporation.

Imports by U.S. affiliates were the equivalent of 35 percent of total U.S. imports in 1987, and 26 percent were from the foreign parent. An examination of trade with individual countries tells an even more dramatic story. Exports by Japanese affiliates were the equivalent of 69 percent of all U.S. exports to Japan, while imports were 81 percent of total U.S. imports from Japan.

The same pattern is true for some other countries, as well, particularly for imports. For example, the equivalent of 60 percent of U.S. imports from Germany are to U.S. affiliates of foreign firms. The bulk of U.S. affiliates' imports from all countries except Canada are finished goods shipped to foreign owned companies that sell them in the United States.

The manufacturing sector, where parts are shipped for assembly and to finish products in the United States accounts for a relatively small portion of affiliate trade. However, Japan accounts for a large share of affiliate trade and manufacturers, relative to the amount of its direct investment in the U.S. manufacturing sector.

The information in table 1 in my testimony indicates that foreign parents and their U.S. affiliates generate significant portions of both U.S. imports and exports.

As such, it suggests the potential for transfer pricing abuse, and the consequent negative effects of tax revenues and the balance of payments by these related foreign firms.

The data in my first table are for all transactions by affiliates, including those with unrelated firms. Tables 2 and 3 present some relevant information on trade between foreign firms and their U.S. affiliates.

Essentially, the information in these tables reinforces the data presented in table 1. In value terms, both by country and by industry, exports of U.S. affiliates to their foreign parents are substantially outweighed by the imports of U.S. affiliates from the foreign parents.

The great majority of U.S. affiliate imports are from the parent company, whereas their exports are divided much more evenly between parents and unrelated purchasers.

This is not surprising considering the U.S. affiliates are primarily distributors of the parents' finished goods, or are producing goods using capital equipment provided by the parent group.

Japanese and West German firms are the biggest exporters and importers, even though neither country's direct investment in the United States ranged in the top two in 1987. Wholesale and retail trade accounts for by far the most affiliate parent trade by industry. The dominance of the wholesale retail, primarily wholesale sector and the parent affiliate trade, again reflect the fact that a large number of U.S. affiliates are distributors.

Table 4 in my testimony gives details on the composition of wholesale trade between parent and U.S. affiliate. U.S. affiliates are not major exporters. What they do export is primarily concentrated in the raw material sector.

Nor do these affiliates produce these products, but serve primarily as middle men to the foreign parents.

Well over half of the exports are made up of two product groups, metals and minerals, and foreign product raw materials. The dollar value of trade from foreign parent to U.S. affiliate is much greater than its opposite.

The bulk of this trade involves transactions through distributors. Not surprisingly, about 50 percent of affiliate imports of finished automobiles, since most Japanese and German cars are imported by distributors that are owned by the manufacturers.

The next largest group of imports are machinery and equipment and electrical goods, capital goods used in affiliates' manufacturing processes. That the preponderance of capital goods imported show up in the wholesale trade sector rather than in the relevant manufacturing sector reflects the fact that unlike in the United States, it is often not the practice of foreign affiliate firms to buy capital goods directly from the producer.

To summarize, what we can conclude from this examination of trade involving foreign owned U.S. affiliates is first, that there is potential for but not necessarily the actuality of transfer pricing abuse, particularly through transactions involving imports by U.S. affiliates from their foreign parent firms. A second conclusion that can be drawn is, because of the great volume of trade between parent and affiliates, if transfer pricing abuses exist to any significant extent, they could have a potentially serious impact on both our tax revenues and balance of payments, and the competitive position of U.S. firms.

Mr. Chairman and members of the subcommittee, I commend you for your efforts in initiating this investigation. We at the Commerce Department will await the results with much interest. I will be happy to answer any questions.

Thank you.

[The prepared statement follows:]

STATEMENT OF
BARBARA N. MCLENNAN
DEPUTY ASSISTANT SECRETARY FOR
TRADE INFORMATION AND ANALYSIS
INTERNATIONAL TRADE ADMINISTRATION
U.S. DEPARTMENT OF COMMERCE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
July 12, 1990

Thank you Mr. Chairman. It is a pleasure for me to appear before the Subcommittee to discuss the Department of Commerce's concerns relating to possible transfer pricing abuse by foreign corporations with U.S. affiliates. For purposes of this testimony, an affiliate is defined to include both subsidiaries and branches of foreign corporations. This is an issue that has received considerable attention lately both within Congress and the Executive branch, and has potentially serious implications for the Federal budget deficit; the U.S. trade balance; and the international competitiveness of American industry.

In fairness, let me state that transfer pricing abuses by U.S. multinationals, in order to shift their tax burden abroad, may have a similar negative impact on the U.S. trade balance. About one-third of U.S. imports are accounted for by U.S. affiliates abroad. This certainly provides the potential for transfer pricing abuses by U.S. multinational firms.

In outlining Commerce's interests in this issue, it is useful to distinguish between transfer pricing per se and the types of transactions that give rise to it. Transfer pricing refers to the valuation of intra-firm exchanges of goods and services. A certain arbitrariness in such valuations can arise because the transactions do not take place on the open market. In the terminology of tax lawyers, the prices that result from these transactions may not be at "arm's length," that is, they may not be comparable to prices for equivalent goods or services paid by independent, unrelated firms in the market.

Although transfer pricing may take place within any firm with multi-divisions or subsidiaries, it only gives rise to the kinds of problems that concern this subcommittee when the transactions take place across international borders. A corporation which has only domestic subsidiaries prepares consolidated balance sheets and income statements for tax and other purposes. Thus any inflated profits or losses of subsidiaries arising from less-than-arm's-length transfer pricing will be offset by artificially low profits or losses of the parent. Total pre- and after-tax corporate profits would be the same as if all pricing were done at arms length, since only one tax code is involved. If, however, the transactions are between a parent domiciled in one country and subsidiaries in other countries, transfer pricing may be used to manipulate and minimize the corporation's total tax liability when the different countries follow different tax policies or tax corporate profits at different rates.

I might also add that the economic equivalent of transfer pricing can take place between unrelated firms. For example, a particular firm selling inputs used in the manufacture of finished goods could favor one or more of its domestic or foreign customers with below-market prices. However, such transactions are not very likely to be observed. First, it is difficult to see the mutual advantage in such an arrangement, unless one firm was willing to assist another in--for example, evading taxes-- in exchange for bargain-priced inputs.

Second, such a pricing practice would be difficult to conceal, and market discipline would come into play. Unless the offending firm had substantial market power, those firms not being favored by less-than-arm's-length pricing would take their business elsewhere. If transfer pricing abuses were systematically practiced against foreign customers, in order to preserve a competitive advantage for domestic producers, the home country might be subject to discipline under the rules of GATT if it allowed widespread use of these practices to go on.

The impact of transfer pricing on Federal tax revenue is quite properly the primary concern of Treasury and the Internal Revenue Service. Commerce has no particular expertise to bring to bear on this question. However, transfer pricing practices can affect the current account and overall balance of payments deficits via their effect on Federal budget deficits and are thus of interest to Commerce, particularly the International Trade Administration.

In addition to indirectly affecting the trade balance via the budget deficit, transfer pricing abuses can potentially exert direct effects on the U.S. balance of trade. For example, if a foreign-owned multinational company establishes transfer prices with its U.S. affiliate that are not at arm's length, so that a disproportionate share of the combined company income is allocated to the parent, the U.S. balance of trade, other things equal, will worsen. In this situation, the parent will sell to the U.S. affiliate at prices that are artificially high, resulting in an inflation of imports. At the same time it will compensate the affiliate for value received at less than arm's length prices, reducing the value of U.S. exports. The result is to increase a trade deficit (or reduce a surplus) above (or below) what it otherwise would be. Such transfer pricing practices can have a significant impact on a country's balance of payments when a large portion of its trade consists of intra-company transactions.

In principle, not all transfer pricing abuses need have a negative effect on the balance of payments. Suppose, for example a foreign company lowers the prices it charges to its wholly-owned U.S.-based distributor in order to increase the market share for its goods in the American market. It is possible that in this case the value of U.S. imports from this country will decrease. For such a result to occur, it would be necessary for the domestic demand for the goods to be relatively insensitive to price changes; or the increased purchase of goods from the foreign company in question is largely at the expense of higher-priced foreign suppliers rather than from domestic producers. If either or both of these conditions is met, newly introduced transfer pricing abuses may, but are not likely, to actually improve the U.S. balance of payments.

The two examples of transfer pricing irregularities described above suggest two conflicting motives that foreign firms might have for engaging in such practices. The first, and the one that is the major focus of this hearing, is to shift corporate tax liabilities from the U.S. to the home country. The second motive, and of equal concern to Commerce, is to gain a competitive advantage over domestically controlled firms in either or both the U.S. or foreign markets by, using aggressive transfer pricing to, in effect, subsidize their U.S. affiliates. Let me stress that these motives are conflicting, and could not be achieved simultaneously by a given foreign firm. If the parent firm sells imputs to its U.S. affiliate at artificially high prices it is obviously not enhancing its competitive position vis a vis U.S. rivals.

This use of abusive transfer pricing by foreign firms to enhance their competitive position may or may not worsen the U.S. trade balance in the short run, though it likely will in the long run if foreign firms and their U.S. affiliates succeed in gaining market share internationally. However, whatever the effect of transfer pricing abuses on the balance of payments, if they adversely affect the ability of U.S. business to compete in international markets, they are of concern to Commerce, and the International Trade Administration particularly.

The potential for transfer pricing (and its abuse) has probably increased with the rapid growth of foreign direct investment in the United States (FDIUS), and the increase in the number of U.S. affiliates of foreign-owned firms. Foreign direct investment in the United States increased by over $300 billion in the 1980s. At the end of 1980, the book value of foreign investments was $83 billion; by the end of 1989 it had risen to $401 billion. FDIUS grew at an annual average rate of 19 percent from 1980 to 1989, clearly outpacing either the growth in the world economy or of global trade. At the same time, the growth of U.S. direct investment abroad (USDIA) was slowing down. In 1980 the U.S. accounted for 43 percent of worldwide outward direct investment, and only 16 percent of inward investment. By 1987 USDIA was only 32 percent of the worldwide total, while one in every four dollars of inwardly directed investment flowed into the United States.

The U.S. manufacturing sector has attracted the most FDIUS, accounting for two-fifths of the total in 1989, followed by wholesale and retail trade, with nearly one-fifth of the total. Real estate was a distant third, accounting for less than one-tenth of the total. Direct investments in both of the first two sectors can potentially give rise to transfer pricing abuses.

If transfer pricing abuses exist they would show up in cross-border, intra company trade. The following table, compiled from 1987 data of FDIUS prepared by the Bureau of Economic Analysis, summarizes trade between foreign firms and their U.S. subsidiaries by industry and country. What is striking about this data is how much of U.S. international trade, particularly imports, are accounted for by parent-affiliate trade. Of total U.S. exports, the equivalent of 19 percent came from affiliates of foreign corporations in 1987, and 8 percent of these exports were to the foreign parent corporation. Imports by U.S. affiliates were the equivalent of 35 percent of total U.S. imports in 1987, and 26 percent were from the foreign parent.

An examination of trade with individual countries tells an even more dramatic story. Exports by Japanese affiliates were the equivalent of 69 percent of all U.S. exports to Japan, while imports were 81 percent of total U.S. imports from Japan. This same pattern is true for some other countries as well, particularly for imports. For example, the equivalent of 60 percent of U.S. imports from Germany are to U.S. affiliates of foreign firms.

The bulk of U.S. affiliate imports from all countries except Canada are finished goods shipped to foreign-owned distribution companies that sell them in the United States. The manufacturing sector--where parts are shipped for assembly into finished products in the U.S.--accounts for a relatively small portion of affiliate trade. However, Japan accounts for a large share of affiliate trade in manufactures relative to the amount of its direct investment in the U.S. manufacturing sector.

The information in Table 1 indicates that foreign parents and their U.S. affiliates generate significant portions of both U.S. imports and exports. As such, it suggests the potential for transfer pricing abuse--and the consequent negative effects on tax revenues and the balance of payments--by these related foreign firms.

The data in Table 1 are for all transactions by affiliates, including those with unrelated firms. However, as I described above, transfer pricing abuses are only likely to occur in

Table 1--U.S. EXPORTS AND IMPORTS OF FOREIGN-OWNED U.S.AFFILIATES, 1987
(dollars in millions)

Country Owner	U.S. Exports Shipped by Affiliates	U.S. Imports Shipped to Affiliates
ALL INDUSTRIES		
All Countries	47,929	140,617
Japan	20,838	71,092
Germany	3,364	16,903
United Kingdom	3,683	10,950
Canada	5,034	7,869
France	5,385	4,284
Netherlands	1,432	4,155
MANUFACTURING		
All Countries	14,980	23,420
Japan	1,048	3,661
Germany	2,591	4,191
United Kingdom	2,631	3,380
Canada	4,047	4,116
France	863	1,657
Netherlands	703	1,449
WHOLESALE-RETAIL TRADE		
All Countries	30,464	107,613
Japan	19,682	67,319
Germany	475	12,334
United Kingdom	708	4,658*
Canada	490	3,215*
France	4,282	2,495
Netherlands	307	285

*Data for retail trade are not included to avoid disclosure of information on individual companies.

Sources: Bureau of Economic Analysis, "Foreign Direct Investment in the United States: 1987 Benchmark Survey--Preliminary Results," Tables G-6, G-9. Cited in, Phyllis A. Genther and Donald H. Dalton, "Japanese Direct Investment in U.S Manufacturing," Table 6, U.S. Department of Commerce, June, 1990.

Table 2--**U.S. MERCHANDISE TRADE BETWEEN FOREIGN PARENTS AND THEIR U.S. AFFILIATES BY MAJOR INVESTING COUNTRY, 1987**
(dollars in millions)

	Exports shipped by affiliates		Imports shipped to affiliates	
Country of Owner	To the foreign parent group	Other	By the foreign parent group	Other
ALL COUNTRIES, ALL INDUSTRIES	19,571	28,359	106,194	34,423
Japan	11,192	9,646	56,938	14,154
Germany	1,348	2,016	14,899	2,004
United Kingdom	1,115	2,568	5,124	5,826
Canada	951	4,083	5,559	2,331
France	931	4,453	3,175	1,109
Netherlands	742	690	1,321	2,834

Source: Bureau of Economic of Economic Analysis, "Foreign Direct Investment in the United States: 1987 Benchmark Survey--Preliminary Results," Table G-4.

Table 3--**U.S. MERCHANDISE TRADE BETWEEN FOREIGN PARENTS AND THEIR U.S. AFFILIATES BY INDUSTRY, 1987**
(dollars in millions)

	Exports shipped by affiliates		Imports shipped to affiliates	
Other foreign	To the parent group	Other	By the foreign parent group	
Petroleum	536	702	3,843	5,138
Food & kindred prod.	165	349	964	694
Chemicals & allied products	1,686	5,083	3,126	1,977
Primary & fabricated metals	375	1,100	2,657	1,199
Non-electrical machinery	520	727	2,351	458
Electric & electronic machinery	856	997	3,096	831
Other manufacturing	868	2,164	4,525	1,543
Wholesale & retail trade	13,767	16,698	85,201	22,412
Other	797	539	431	170

Source: Bureau of Economic Analysis, op.cit. Table G-3.

transactions between affiliate and parent firm. Tables 2 and 3 present some relevant information on "trade" between foreign parents and their U.S. affiliates.

Essentially, the information in these tables reinforces the data presented in Table 1. In value terms, both by country and by industry, exports of U.S. affiliates to their foreign parents are substantially outweighed by the imports of U.S. affiliates from the foreign parent group.

Both tables also illustrate that the great majority of U.S. affiliate imports are from the parent company, whereas their exports are divided much more evenly between parents and unrelated purchasers. This is not surprising considering that U.S. affiliates are primarily distributors of the parents' finished goods, or are producing goods using capital equipment provided by the parent group. Japanese and West German firms are the biggest exporters and importers even though neither country's direct investment in the U.S. ranked in the top two in 1987. Wholesale and retail trade accounts for by far the most affiliate-parent trade by industry. The dominance of the wholesale-retail (primarily wholesale) sector in parent-affiliate trade, again, reflects the fact that a large number of U.S. affiliates are distributorships.

Table 4 gives details on the composition of wholesale trade between parent and U.S. affiliate. U.S. affiliates are not major exporters. What they do export is primarily concentrated in the raw materials sector. Nor do these affiliates produce these products, but serve primarily as "middlemen" to their foreign parents. Well over half of the exports are made up of two product groups, metals and minerals, and farm product raw materials.

Table 4--COMPOSITION OF WHOLESALE TRADE BETWEEN FOREIGN PARENT FIRMS AND THEIR U.S. AFFILIATES, 1987
(dollars in millions)

Product Group	Exports of Affiliates	Imports to Affiliates
Total	13,670	84,123
Motor vehicles & equipment	1,696	42,733
Professional & commercial equip.	88	5,520
Metals & minerals	5,490	7,897
Electrical goods	695	14,635
Machinery & equip.	612	3,965
Other durables	484	2,539
Groceries, etc.	750	1,728
Farm product raw materials	3,511	965
Other non-durables	343	4,110

Source: Bureau of Economic Analysis, op.cit., Table G-3.

The trade from parent to U.S. affiliate is much more important than its opposite. Again the bulk of it involves transactions through distributors. Not surprisingly, about 50 percent of affiliate imports are finished automobiles, since most Japanese and German cars are imported by distributors that are owned by manufacturers.

The next largest groups of imports are machinery and equipment, and electrical goods--capital goods used in affiliates' manufacturing processes. That the preponderance of capital goods imports show up in the wholesale trade sector, rather than in the relevant manufacturing sector, reflects the fact that, unlike in the U.S., it is often not the practice of foreign affiliate firms to buy capital goods directly from the producer.

To summarize, what we can conclude from this examination of trade involving foreign-owned U.S. affiliates of is, first, that there is the potential for, but not necessarily the actuality of, transfer pricing abuse, particularly through transactions involving imports by U.S. affiliates from their foreign parent firms.

A second conclusion that can be drawn is, because of the great volume of trade between parent and affiliates, if transfer pricing abuses exist to any significant extent, they could have a potentially serious impact on both our tax revenues and balance of payments, and the competitive position of U.S. firms.

Mr. Chairman, and Members of the Subcommittee, I commend you on your efforts in initiating this investigation into the pricing practices of foreign firms and their U.S. affiliates. We at the Commerce Department shall await the results with much interest.

I will be happy to answer any questions.

Mr. DORGAN. Thank you very much for your testimony.

Is it Mr. Sailer, or Siler?

Mr. SAILER. Yes, sir, Mr. Chairman, it's Mr. Sailer.

Mr. DORGAN. You may proceed. Your entire statement will be made a permanent part of the record, and we would appreciate it if you would summarize.

STATEMENT OF FRANCIS J. SAILER, DEPUTY ASSISTANT SECRETARY FOR INVESTIGATIONS, IMPORT ADMINISTRATION, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. SAILER. Thank you, Mr. Chairman, members of the subcommittee.

If I may, I would like to begin with some brief but important background remarks regarding dumping and our role in enforcing the anti-dumping laws. I will then address the topics that the subcommittee requested us to describe, specifically the importance of the antidumping questionnaire, the role of transfer pricing in dumping cases, and the problems we foresee in sharing proprietary information with other parts of the Government.

The Commerce Department's International Trade Administration is responsible for administering programs designed to assist U.S. industry and labor compete in the world market and combat unfair foreign trade practices. Import Administration, one of the four subdivisions of the International Trade Administration, administers among other things the antidumping laws. Under those laws, American manufacturers may request the Department to investigate and determine whether foreign producers are unfairly pricing or dumping products in the U.S. market and to impose duties to offset the effects of that dumping.

Dumping occurs when foreign producers sell their products at prices lower in the U.S. market than in their home market or other export markets, causing injury to the U.S. industry. Dumping may also occur when sales to the United States are made at prices below the cost of manufacturing and selling the product. These low priced sales are referred to as sales at less than fair value and the dumping laws require that a duty be imposed on the imported merchandise.

The amount of duty is generally equal to the difference between the product's lower U.S. sales price in those cases where the U.S. price is lower than the higher foreign market sales price or foreign market value.

The antidumping laws and the Commerce Department's regulations direct us in determining a manufacturer's U.S. price and foreign market value, for a foreign produced good, and in calculating the amount of any antidumping duty.

Under the laws, the U.S. price is derived from the price paid by the first unrelated buyer in the United States. In contrast, foreign market value may be based on one of three different values: a home market selling price, selling price in a third country export market, or constructed value, a term used in the dumping law to describe the sum of the product's manufacturing costs, general expenses, and profit.

Depending upon the situation, each of these foreign market values may be compared to the U.S. price to determine whether dumping is occurring. As administrator of the dumping laws, Import Administration collects sales data and other business sensitive information from foreign producers accused of dumping their merchandise in the U.S. market.

Case analysts at Import Administration carefully evaluate this information, using it to derive the foreign product's U.S. price, the foreign market value, and the amount of antidumping duty to be assessed by the Custom Service.

This highly sensitive information is collected through Import Administration's antidumping questionnaire. The questionnaire, in the course of a proceeding, is sent to each of the foreign producers taking part in the case. Their voluntary responses furnish the information necessary to conduct the proceeding in a fair manner and to reach a dumping determination.

Consequently, the questionnaire is vital to the successful completion of any dumping case. The case analyst prepares a dumping questionnaire following a general format, requesting several specific categories of information from foreign producers.

Section A of our questionnaire requests general information regarding the foreign producer's corporate structure and sales practices, a description of the merchandise alleged to be dumped, and the volume of sales for that merchandise in all of the producer's markets.

Sections B and C request listings of all U.S. and foreign market sales transactions and related expenses incurred during a specified period.

Sections D of the questionnaire is on the manufacturing costs of the merchandise. Unlike sections A, B, and C, section D is not included in every questionnaire. Rather, we request the foreign producer's manufacturing cost information, through the use of section D, only if constructed value will be used as the basis for foreign market value or if we have reason to believe that foreign market sales are being made at below the cost of production.

For some dumping cases, we may require specific additional information, in which case supplemental questionnaires go out to the foreign producers. These supplemental questionnaires typically request information regarding further U.S. manufacturing of the subject merchandise through trading companies or other case specific information deemed necessary by the Department to its dumping analysis.

Concerning the use of transfer price information and dumping proceedings, Import Administration does solicit such data from foreign producers through some of its questionnaires, but uses such information only in cases involving certain issues and where specific conditions exist.

Transfer prices do not affect the determination of a foreign producer's U.S. price, nor do they generally affect the determination of a foreign market value based on sales prices.

Transfer prices are most often a factor when a producer's manufacturing cost data must be used to establish the product's foreign market value on the basis of constructed value.

Even in these situations, however, transfer prices have a limited function, since they are only used to value parts, subassemblies, or other manufacturing inputs purchased by the foreign producer from its related suppliers.

Furthermore, we only accept transfer prices if they are at prices reflective of an arm's-length transaction and are not below the input's manufacturing cost.

I should note that transfer prices also play a role in circumvention inquiries conducted pursuant to provisions of the Trade and Competitiveness Act of 1988. In judging whether a foreign producer is in fact attempting to circumvent an existing antidumping order by shifting its manufacturing operations to a country other than the country subject to the antidumping order, we may use transfer prices to value parts, components, and subassemblies shipped from the country that is subject to the antidumping order. These prices, however, must not be less than the manufacturing costs of the involved input.

Turning to the possibility of sharing transfer price data and other information that we collect in an antidumping case with any other Government body, it's clear that to do so would not only be a serious violation of U.S. law, but an egregious breach of the U.S.'s international obligations.

Under the General Agreement on Tariffs and Trade, or the GATT, the United States has agreed to restrict the use and disclosure of any business proprietary information it receives in the course of an antidumping proceeding.

GATT clearly states that sensitive business information submitted in antidumping investigations may only be obtained by parties to the proceeding, by the investigating government's administering authority or other agencies involved in administering the trade laws.

Allowing any other part of our Government access to such data would undoubtedly be considered a violation of the GATT and could result in trade retaliation measures aimed at innocent U.S. exporters.

Moreover, in U.S. legislation, Congress has recognized a participant's right to confidentiality in an antidumping proceeding and implemented the GATT restrictions on access to sensitive business data in U.S. law.

Other than the three Federal agencies directly involved in an antidumping case or the collection of antidumping duties, only representatives for parties to a proceeding may obtain that data and then only through a narrowly drawn and rigorously enforced administrative protective order.

Although the serious legal restraints against our sharing proprietary data are clear, you should be aware of the impact on the U.S. antidumping enforcement program should there ever be a requirement that we share antidumping related information.

In conducting antidumping proceedings, Import Administration solicits from foreign producers their most sensitive business information, including information on prices, costs and expenses, customer names, and in many cases, production techniques and trade secrets, collected through a series of questionnaires.

Responses to these questionnaires are not mandatory. However, our ability to guarantee the confidentiality of such information is an important element in obtaining voluntary cooperation from most foreign producers.

If foreign producers knew that the sensitive information they submitted to the Import Administration could be made available to the IRS and/or other parts of the U.S. Government, our ability to obtain data for cases would be severely inhibited.

From a technical perspective, it's important to note that the data we receive might not be particularly useful to the IRS. Import Administration prepares its questionnaires for the specific purpose of investigating whether dumping as defined in the statute is occurring. The responses we receive may be irrelevant or even misleading to the IRS.

I suppose one might contend that the antidumping information received from a foreign producer could be reconciled with information reported for tax purposes. Whether or not this is true, reconciliation would be a formidable task requiring extensive time and resources, as well as expertise that only Import Administration possesses.

Certainly Import Administration, with all of its statutory responsibilities, could not assume either the administrative burden of assisting the IRS in an attempt to convert antidumping questionnaire information to a more meaningful form for tax purposes or the legal responsibility of verifying any conclusions the Service might draw from its analyses.

While we recognize the fact that the IRS has its own important mission to accomplish, requiring Import Administration to provide it with proprietary information obtained in an antidumping proceeding would adversely affect our ability to collect information and administer the antidumping laws in a fair and equitable manner.

More importantly, sharing proprietary data with any arm of the Federal Government not a party to an antidumping proceeding would be a serious violation to both domestic law and international agreements.

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to present testimony on behalf of Import Administration this afternoon and would be glad to answer any questions you might have.

Thank you.

[The prepared statement follows:]

STATEMENT OF FRANCIS J. SAILER, DEPUTY ASSISTANT SECRETARY FOR INVESTIGATIONS, INTERNATIONAL TRADE ADMINISTRATION, IMPORT ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. Chairman and members of the Subcommittee, it is a pleasure to appear before you today to present testimony on behalf of the Import Administration sector in the Department of Commerce with regard to transfer pricing and the Department's antidumping program.

The Commerce Department's International Trade Administration is responsible for administering laws designed to help U.S. industry and labor combat unfair foreign trade practices. Import Administration, one of the four subdivisions of the International Trade Administration, administers the antidumping laws. Under those laws, American manufacturers or unions can ask the Department to investigate and determine whether foreign producers are dumping a product on the United States market, and to impose antidumping duties to offset the dumping.

Dumping occurs when foreign producers sell their products at a lower price in the United States market than in their home or other export markets, causing injury to the U.S. industry. Dumping can also occur when sales to the United States are below the cost of producing and selling the product. Such low-priced sales are referred to as sales at less than fair value, and the antidumping duty law provides a remedy in the form of duties imposed on the imported merchandise.

The existence of sales at less than fair value alone does not result in antidumping duties being levied on imports. International agreements and the statute require a second test before an antidumping order can be issued. At the same time that Import Administration is determining whether, and to what extent, sales at less than fair value exist, the United States International Trade Commission conducts an investigation to determine if those sales are injuring the U.S. industry. Imports are subject to antidumping duties only if a foreign producer's sales are concurrently determined, (1), to be at prices that are less than fair value and, (2), to injure the U.S. industry. If both conditions are determined to exist, the Department issues an antidumping order.

Antidumping duties are assessed on imported merchandise through an administrative review process. The amount of the duty, or dumping margin as it is often called, is generally equal to the difference between the lower U.S. sales price and the higher foreign market sales price for a foreign-produced good.

CALCULATION OF THE DUMPING MARGIN

To calculate the antidumping duty, the imported product's United States sales price, which we call the United States Price, is derived from the price paid by the first unrelated buyer in the United States. By contrast, the Foreign Market Value may be based on one of three potential values: the home market selling price, the selling price in export markets other than the United States (so-called third-country markets), or its constructed value (a term used in the antidumping law to describe the sum of a product's manufacturing costs, general expenses, and profit). Depending upon the situation, each of these Foreign Market Values may be compared to the United States Price to determine the dumping margin.

The antidumping law and Commerce regulations provide guidelines for selecting the Foreign Market Value to be compared with the United States Price. When available in sufficient commercial quantities, Import Administration uses home market sales as the basis for Foreign Market Value. If, however, we determine that there are insufficient home market sales (for example, if the product is manufactured solely for export), then third-country sales become the basis. Lastly, if foreign market sales are unavailable or available only in quantities that are commercially insufficient for comparison, we resort to constructed value as the basis for determining Foreign Market Value. This hierarchy clearly illustrates the statute's preference for identifying dumping by comparing actual United States and foreign market selling prices. Constructed value comparisons are made, generally, when circumstances do not permit a reliable price-to-price analysis.

Having described the rule for determining a product's Foreign Market Value, I can now give you the inevitable exception to the rule. In antidumping cases, we typically find that sales in the foreign producer's home or third country export markets are made in quantities sufficient for comparison to the U.S. sales price. Further investigation, however, sometimes reveals foreign market sales at prices so low that the producer could not have expected to recover its production costs within a reasonable period of time. Under these circumstances, the normal price-to-price comparison between the two markets does not provide a credible measure of the producer's dumping margins. Instead, we rely on constructed value as the basis for Foreign Market Value.

While simply comparing market prices to determine a dumping margin may appear quite simple in theory, in practice, it is not. There are numerous factors that must be considered in order to make an "apples-to-apples" comparison between sales of merchandise in the U.S. market and sales of identical or similar merchandise in the foreign market. For example, we may find that advertising costs or other selling expenses are different in the two comparison markets. The law refers to variations between market selling expenses as differences in the circumstances of sale and requires that we adjust the sales prices to compensate for those differences.

Circumstances-of-sale differences are but one of the many categories of variables that affect a product's price across markets. Other such variations include differences in shipping or movement expenses, discounts, rebates, and sales quantities. In many cases, we must also adjust for differences in the physical characteristics of the products sold in each market.

Comparing prices without first compensating for legitimate differences would lead to meaningless results in our dumping analysis. To avoid such results and to provide a uniform basis for comparison, we adjust both U.S. and foreign market sales prices to derive an ex-factory sales price for the product in each market. Loosely defined, the term ex-factory price refers to the price of the finished merchandise packed for shipment to the United States. As such, it provides the most reliable measure of price discrimination across markets.

Given the variety of industries and products which we are required to investigate, each antidumping case is unique in the issues and challenges it presents. In Import Administration we are fortunate to have a staff of intelligent, hardworking and dedicated employees to direct each case and to ensure that proceedings progress effectively, fairly, and as expeditiously as possible.

INVESTIGATIONS

The typical antidumping case begins when a petition is filed on behalf of a U.S. industry. The petition includes data to support the claim that foreign merchandise is being sold at less than fair value and that

the U.S. industry is being materially injured. Import Administration reviews the petition to assess the validity of the petitioner's claim that foreign products are being dumped on the U.S. market. (As I discussed earlier, the International Trade Commission will determine if the petitioning industry has been injured by the alleged dumping.) If the submitted petition reveals reasonable evidence that dumping exists, Import Administration initiates an antidumping investigation. The investigation begins with the presentation of an antidumping questionnaire to the foreign producers.

In the antidumping questionnaire we ask the foreign producers to voluntarily provide all of the information necessary for us to conduct our investigation and to reach a dumping determination. Consequently, the questionnaire is vital to the success of any antidumping case.

The Import Administration analyst prepares the antidumping questionnaire, following a general format. Section A of the questionnaire requests information regarding the foreign producer's corporate structure and practices, a description of the investigated merchandise that it sells, and the volume of sales for that merchandise in all markets.

Sections B and C of the questionnaire request listings of U.S. and foreign market sales for use in determining the United States Price and Foreign Market Value of the merchandise. The listings cover a specific time period, typically six months, referred to as the period of investigation.

Section D of the questionnaire requests cost of production and constructed value information. Unlike Sections A, B and C, which focus on the sales of the subject merchandise, Section D focuses on the manufacture of the merchandise. We do not, however, include this section in every questionnaire. Instead, we only request this information if constructed value will be used as the basis for Foreign Market Value, or if we have reason to believe that foreign market sales are at prices below their production costs.

For some antidumping cases, we may require specific additional information. When this occurs, we issue supplemental questionnaires to the foreign respondents. These questionnaires typically request information regarding further U.S. manufacturing of the subject merchandise, resale of the merchandise through trading companies, other case-specific information, or corrections of deficiencies in prior responses.

After receiving a response to the questionnaire, Import Administration evaluates the information and determines, preliminarily, whether the respondent company is selling at dumped prices. If the preliminary determination is affirmative, that is, the respondent is found to be selling at less than fair value, then we instruct the U.S. Customs Service to collect a bond from the importer to secure the duty, and to withhold final action on the entry documents. This process is referred to as suspension of liquidation, and the U.S. Customs Service is responsible for its enforcement. If, on the other hand, the preliminary determination is negative, then there is no suspension of liquidation. The investigation itself, however, continues to its next phase.

Having performed a preliminary evaluation of the respondent's questionnaire data, the analyst must verify its accuracy. Verification takes place at the foreign producer's premises, using company books and records as source documentation. The verification results are summarized by the case analyst in a written report.

The verified information is used by the analyst to prepare the final dumping determination. If the Import Administration determination is affirmative, and if the International Trade Commission's injury determination is affirmative, Import Administration issues an antidumping order. The order puts Customs and the public on notice that future imports, as well as those since the original suspension of liquidation, are subject to the assessment of antidumping duties. In addition Customs begins to collect a cash deposit of estimated antidumping duties at the rate specified in the final determination. At this point, bonds or other forms of securities are no longer acceptable.

ADMINISTRATIVE REVIEWS

Antidumping orders are subject to an administrative review process. Each year, beginning on the anniversary date of the order, interested parties (typically U.S. or foreign producers) may request that Import Administration examine imports of the product in the most recent period, that is, an annual period following the original investigation or last administrative review. The purpose of the administrative review is to ascertain the degree of dumping during the period reviewed, and to finally assess dumping duties on importations during that period. If no review is requested, assessment is at the rate of estimated antidumping duties required when the goods were imported.

Procedures in a review are similar to those in an investigation. Once again, a questionnaire is sent to the foreign respondent, and its response becomes the basis for the dumping determination. Import Administration evaluates the respondent's data, prepares a preliminary determination, often verifies the accuracy of the data, and issues a final determination.

TRANSFER PRICING

You have asked that I address the issue of transfer pricing and its role in the Department's antidumping program. I would first like to emphasize the very limited role that transfer prices play in price-to-price antidumping analyses.

Recall that, in its most basic form, the dumping calculation consists of two elements, the United States Price and the Foreign Market Value. These two elements are compared to compute the dumping margin. As I mentioned earlier, the United States Price is derived from the price paid by the first unrelated U.S. buyer in an arm's length transaction. We do not, for example, base the United States Price of imported merchandise on the amount a U.S. subsidiary pays to its foreign parent. Consequently, transfer pricing is not an issue in deriving a foreign producer's United States Price.

With respect to establishing the Foreign Market Value, we most often use sales between a foreign producer and its unrelated home or third country customer. Depending on the circumstances, we may derive the Foreign Market Value from a producer's sales to related customers, but only if that producer can demonstrate that such sales were made at arm's length or at prices and terms comparable to those given to an unrelated customer. In other words, the finished good's transfer price must, in effect, be its market price before we can accept it as the basis for Foreign Market Value.

There is one other situation in which transfer prices may potentially play a role in determining a price-based Foreign Market Value. In price-to-price comparisons, we prefer to compare the product's United States price to the price of the identical product sold in the foreign market. We may find, however, that the merchandise sold by the foreign producer in the United States is not exactly the same as it sells in the foreign market.

Under these circumstances, we compare the products from each market that are the most similar to one another in terms of their physical characteristics. The foreign market price is adjusted before comparison to account for the two product's dissimilar features. This is referred to as a difference in merchandise, or difmer, adjustment, and is calculated as the net difference between the manufacturing costs of the product sold in the United States and its foreign market comparison. In antidumping cases involving difmer adjustments, we request that the foreign producers submit manufacturing cost information in their questionnaire responses. The requested information generally consists of cost data for the materials, labor and variable overhead that went into producing the comparison products sold in the United States and foreign markets.

Transfer prices play a role in calculating the difmer adjustment when foreign producers purchase parts, subassemblies or other manufacturing inputs from related suppliers for use in the finished good. In these cases, we allow the producers to report their transfer prices as the value of the inputs received from the related suppliers, but only if those prices reflect an arm's length transaction and are above the input's total manufacturing cost. Should the transfer price of a production input be less than its market price or below the manufacturing cost, we would then value the input at its actual manufacturing cost.

Given that transfer pricing is largely irrelevant to the determination of United States Price, and used only in specific situations to establish a price-based Foreign Market Value, you can correctly conclude that many of our antidumping cases do not touch upon issues of transfer pricing.

In general, when at issue in an antidumping case, transfer prices are most often found in calculating the cost of production or constructed value of a product. In addition, they may have an impact on circumvention inquiries. Circumvention is essentially an attempt by a foreign producer to evade an existing antidumping duty order by shifting its manufacturing operations to a country not covered by the order.

As I mentioned earlier, when foreign market sales are made at prices below manufacturing costs, we use the product's constructed value, rather than its foreign sales price, as the basis for Foreign Market Value. We compare the cost of production for the foreign market product to the foreign market sales price to determine the existence of below cost sales. As part of our analysis, we request that foreign producers submit cost of production information in their questionnaire responses.

This information is more extensive than that reported for difmer adjustments, in that it is intended to capture all direct and indirect production costs rather than just those costs associated with the physical differences in the products. The cost of production data that we request not only includes the manufacturing and variable overhead costs of the product, but also its fixed overhead costs and an allocated share of the producer's general expenses.

The use of transfer prices in calculating the foreign product's cost of production is similar to that in the difmer adjustment. Here again, when foreign producers purchase manufacturing inputs from related suppliers, these inputs may be valued at their arm's length transfer price, as long as that price is above the input's manufacturing cost.

As I noted earlier, in constructed value cases, we use the product's total manufacturing costs, allocated general expenses and profit as a surrogate for Foreign Market Value when the preferred price-to-price comparison is either unavailable or unreliable. The information that we request from foreign producers and use to calculate constructed value is, for the most part, the same as that requested in a cost of production analysis. As such, transfer prices are only submitted for sales of manufacturing inputs between the foreign producer and its related supplier, and again, only under those conditions I outlined in my previous remarks.

The transfer price information submitted in a circumvention inquiry is somewhat different than that in cost of production and constructed value cases. In a typical circumvention case, a foreign producer whose product is subject to U.S. antidumping duties may ship the product to a U.S. subsidiary in an unfinished form that is outside the scope of the order. Once imported, the U.S. subsidiary would complete the product's manufacture and sell it at a dumped price. In judging whether a foreign producer is, in fact, attempting to circumvent an order, we focus on the extent of value added in the country where the product's manufacture is completed. If the difference between the value of the parts and components imported from the country subject to the order and the value of the final produce is small, then we may determine that circumvention does exist.

As you can see, transfer prices play a limited role in antidumping cases.

DATA SHARING

You have also asked that we comment on the possibility of sharing the proprietary data that we collect in antidumping proceedings with the Internal Revenue Service or other Federal agencies. Our basic position is quite simple: to do so would be a violation of U.S. law and international agreements. Furthermore, it would be counterproductive.

First, under the General Agreement on Tariffs and Trade, or GATT, the United States has agreed to restrict the use and disclosure of any business proprietary information it receives in the course of an antidumping proceeding. Under GATT, sensitive business data submitted in antidumping investigations can only be obtained by parties to the proceeding or by the investigating government agency. Allowing other government agencies access to such data would undoubtedly be considered a violation of the international agreement by those countries whose companies were affected.

In U.S. legislation, Congress recognized a participant's right to confidentiality in an antidumping proceeding. Provisions of the Tariff Act support the international agreement restricting access to sensitive business data. Other than the Federal agencies directly involved in an antidumping case, only representatives for parties to a proceeding may obtain proprietary data, and then only through a narrowly drawn administrative protective order. These administrative protective orders are no mere formality. On the contrary, they ensure the confidentiality of participating parties through a set of detailed undertakings and procedures that applicants must agree to and follow. Violaters of the protective order restrictions face serious sanctions from the Department.

Import Administration cannot release proprietary data to the Internal Revenue Service under the law. If it were to do so, the submitting party would have recourse to the U.S. Court of International Trade.

In the same vein, an affected country could pursue an action against the United States through a GATT dispute settlement panel. If the United States did not accept the likely adverse decision of the panel, the affected country would then be permitted to resort to unilateral action against the United States. Such action could include trade retaliation measures which could cause hardship to innocent U.S. industries.

Although the serious legal restraints against a program of sharing proprietary data are clear, I also want to call your attention to the serious consequences that a data-sharing plan would have on the United States' antidumping enforcement program.

In conducting antidumping investigations and reviews, Import Administration solicits from foreign producers their most sensitive business information, including information on prices, costs, customers, and in many cases, production techniques. As I explained earlier, this information is collected through a series of questionnaires. While responses to Import Administration questionnaires are not mandatory, our ability to guarantee the confidentiality of such information is an important element in obtaining voluntary cooperation from most foreign producers.

Our only recourse for compelling compliance in an antidumping case is a practice of using surrogate information, referred to as the best information available, in order to calculate dumping margins. Generally, adverse inferences are made in determining the best information available for uncooperative foreign producers. The firms' awareness of this practice serves to encourage their useful participation in antidumping proceedings.

If foreign producers know that information they submit could become available to the Internal Revenue Service, Import Administration's ability to obtain data for its cases would be severely inhibited, notwithstanding the threat posed by best information available. Foreign producers would be forced to weigh the advantages, disadvantages, or uncertainties of cooperating in an antidumping proceeding against the disadvantages of an adverse determination based on best information available. As a result, they could refuse to submit the information requested in our antidumping questionnaire. Thus, foreign producers would subject themselves and their U.S. importers to adverse determinations based on best information available, but for reasons unrelated to the antidumping proceedings.

From a technical perspective, we also note that our data might not be particularly useful to the Internal Revenue Service. We do not understand exactly what the Internal Revenue Service intends to do with the antidumping information collected by Import Administration. However, no matter what its intended purpose, we can reasonably conclude that the information will require significant reconciliation before it is in a form consistent with that used by the Internal Revenue Service. This problem results from the fact that Import Administration and Internal Revenue have dissimilar purposes for obtaining information from corporations.

Import Administration prepares its questionnaire for the specific purpose of investigating antidumping and the response it receives may be irrelevant or even misleading to the Internal Revenue Service. Some may contend that the antidumping information received from a foreign producer should be reconcilable with information reported for tax purposes. Whether or not this is correct, reconciliation would be a formidable task requiring extensive time and resources, as well as expertise that only Import Administration possesses. Moreover, Import Administration could not assume either the administrative burden of assisting the Internal Revenue Service in an attempt to convert questionnaire responses to a more meaningful form, or the legal responsibility of verifying any conclusions the Service might draw from its analyses.

While the Internal Revenue Service has its own important mission to accomplish, requiring Import Administration to provide it with proprietary information obtained in an antidumping proceeding would adversely affect our ability to collect information and administer the antidumping law in a fair manner. More importantly, sharing proprietary information with any Federal agency that is not a party to an antidumping proceeding would be a serious violation of both domestic law and international agreements.

Chairman PICKLE. We thank you very much for your testimony, both of you, and your testimony is very helpful.

Mr. Schulze, do you have any questions?

Mr. SCHULZE. Thank you, Mr. Chairman.

Yes, I do. Mr. Sailer, will you describe for me how the Commerce Department gets involved with transfer pricing issues?

Mr. SAILER. Well, periodically in our questionnaires, we will request transfer price information. One example that comes to mind that has been referenced in other contexts here today is in the assembly of foreign merchandise in the United States. If a product is subject to an antidumping order and a foreign company attempts or at least arguably attempts to circumvent that order by shipping parts and components instead of the completed article, we need some method of determining the value of the parts and components that are imported into the United States.

Among other things, we seek transfer prices in that instance to determine the value of the Japanese inputs as opposed to the inputs from the United States and other sources.

That is one example of when transfer prices are requested. And that may be perhaps the most—the most relevant to any aspect of our cases.

Another instance where we seek transfer prices is in determining foreign market value. If a foreign manufacturer is selling a completed article to the United States and we ultimately will conduct either a constructed value analysis or a cost of production analysis, we are required to build up their cost of production, which may include inputs that they have purchased from related suppliers in their foreign market. In such a case we will request and analyze their transfer prices.

Mr. SCHULZE. In the case of transfer pricing where the item sold is higher, it really wouldn't become apparent in an antidumping action, would it?

In other words, that would be the exception rather than the rule?

Mr. SAILER. I am sorry, I don't understand your question.

Mr. SCHULZE. Well, when an object or an item is being sold to a U.S. company or in competition with a U.S. company and that price is artificially inflated going in, in other words, it's higher priced, it's less likely to become subject to a dumping action; isn't that correct?

Mr. SAILER. Arguably. It depends upon the amount of information that the U.S. industry has that may reflect otherwise.

When we go to look at those prices, we are not simply——

Mr. SCHULZE. You are saying that that is not necessarily true. The overall price might be so low, even despite the fact that the distributor's price is inflated, that it still could be a target for another company?

Mr. SAILER. That is true; yes, sir.

Mr. SCHULZE. That seems a little incongruous to me. I didn't realize the price differential would be that great.

Mr. SAILER. Well, I obviously cannot talk about specific cases, but we see some very large price discrepancies.

Mr. SCHULZE. Well, what I was getting at is that common sense leads me to believe that those items that we discover through an antidumping investigation would be a very small portion of the overall problem.

Mr. SAILER. That could very well be the case. As I understand it, the main purpose of your interest in our involvement here is in those cases that do result in dumping cases; and in determining whether we collect and use transfer prices.

Mr. SCHULZE. OK. What antidumping cases either have been filed or are pending or even filed and closed? What is going on with motorcycles and electrical equipment distributors and manufacturers?

Are you free to tell us that?

Mr. SAILER. There are currently, I believe, no antidumping investigations or compliance reviews ongoing with respect to automobiles or motorcycles.

There are a number of electronic related items currently subject to investigations, and many more are subject to administrative reviews.

Mr. SCHULZE. If there is an instance of dumping which would involve transfer pricing, it would, it seems to me, more be a coercive type of dumping on a captive subsidiary.

Is that a correct assumption? In other words, the product that couldn't be sold on the world market for some reason, you would force a distributor to take some of that product and then try to unload it at low prices. So it would not be a coercive type situation.

Mr. SAILER. Well, as I mentioned in my testimony, there are two ways to determine what U.S. prices we use for comparison to a foreign market value. When a sale is made through a U.S. subsidiary of a foreign company, we do not look at that transfer price. What we look to is the foreign subsidiary's sales price to the first unrelated purchaser.

Mr. SCHULZE. Ms. McLennan, you are an expert. Do you have any comments on each of those questions? You are as close to an expert as we are going to have before us.

Ms. MCLENNAN. Mr. Sailer is the expert on the antidumping provisions.

I would like to say, though, that I believe the Import Administration uses the concept of fair market value, which is somewhat different than the IRS's definition of arm's-length pricing, just on a technical basis.

The regulations that have been drafted over the years with respect to section 482 almost provides a methodology for determining what an arm's-length price is, which makes it a different kind of investigation than what Import Administration does.

Mr. SCHULZE. Do you have any suggestions for us. Quite frankly, it's been a problem for many years, and you have been involved for a while. You remember the old American selling price and other things that we have attempted over the years to find a rationale method of determining reasonable prices.

It's been very difficult. Do you have any suggestions for us?

Ms. MCLENNAN. Well, again, I guess you understand that I have had some experience in doing research in this area.

I would like to say that the free market does provide information to firms doing business within it. Companies that try to sell a product know what the costs are. They have an understanding of what kind of margin they can hope to get. They know what their competitors are doing. They know roughly what the market will bear.

If you are doing research on an arm's-length price for a particular product within a particular industry, there are people out there who can help you.

It's possible to do research in this area and to come up with a reasonable understanding for all competitors as to what the arm's-length price is, and if you know what that is, you can determine whether a company is within the ball park that 482 would have you apply to that company.

It's not really true that it's so vague that you cannot quite figure out what a company should be making. People in the industry will be able to tell you, and good researchers will be able to find that out.

Mr. SCHULZE. I agree with you wholeheartedly. but our problem is defining that legislatively. It has been a very knotty problem over the years and one which we have not yet solved.

Ms. McLennan. When the Chairman stated the 8 to 10 percent concept, he was establishing an arm's-length price based on an average for all companies and all industries. He thought that they ought to have an 8- to 10-percent profit, I suppose. Maybe some industries make 1 percent.

You know, you can find 25 percent gross margins for distributors. I am sure, if your staff has talked to a lot of people in this particular area, they found that it's well known that distributors make 25 to 30 percent. But then you will find other distribution companies coming to the fore who will tell you that they never make more than 5 percent.

Now, to determine what the proper rate would be would require research and training, but it's not impossible to do.

Mr. Schulze. Well, I believe you are right, and there are industry norms, competitive norms, and if you know the industry, you know what those averages or norms are.

You have a rather unique background, having been with the IRS, and in your present position. You have had the opportunity to observe both the Japanese trade practices, as well as their culture.

Do you have any thoughts on this situation that we are looking into that might give us some of that insight and the benefit of your ability?

Ms. McLennan. Well, as you know, I worked on transfer pricing studies within the IRS for about 4 years. And some of the companies that I studied were U.S. distributors related to Japanese parent firms.

I have been with the Commerce Department now for a year and I was directly involved with the joint MITI/Department of Commerce' price survey, which was quite a fascinating experience, because I was in the four cities, two of them in Japan, two of them in the United States, pricing capital goods products in both markets.

I found that Japanese businessmen operate very similarly to American businessmen, but that the Japanese market had fewer competitors. I believe that when we look at pricing, we tend to forget what the issue is, the concern that U.S. businesses have an even, competitive, open market.

When you are up against a firm that has the capacity to be subsidized by a foreign parent, because it's not really operating in a competitive marketplace, you get an uneven playing field.

If you look at the distribution process in both countries, you know that in one place, there will be a price leader that essentially says, this is what the price is. Everyone has to take the price in one way or another. You can mark it up or mark it down. But basically, you have to take your price from what the price leader says.

In the other market where you have many more competitors, you really have to be very efficient; if one or another of the competitors can avoid some of the costs, the cost of taxes, for example, they have an unfair advantage. Over the long pull, this kind of subsidy can become very destructive to American industry.

I think we have seen some of the effects of that, not necessarily only from transfer pricing, but from the effect of a kind of oligopoly power practiced by large cartel operations.

I want to commend the committee for looking at the transfer pricing aspect of it, but I think we are up against a much bigger picture in terms of economic policy.

I really want to stress that it's not just the Japanese. We are talking about this kind of operation with respect to other trading partners, and at least we have had real cooperation with the Japanese, opening up the main structural issues. I have to say that the pricing survey couldn't have taken place without the complete cooperation not only of the Japanese Government, but of Japanese firms that were very open in terms of giving us the information we asked for.

In connection with that, I must say I received the most information I ever had in a research project from an American at a trade fair in which he said, "OK, that is my wholesale price, that is my retail price, that is my margin. If anybody undercuts me, I want to know why." In 30 seconds, he told me more than anybody else had in any pricing survey I had done over the last 5 years. That is what the competitive marketplace does. The people operating within it know it's going on, because they have to react to it quickly and efficiently.

Mr. SCHULZE. Thank you.

Chairman PICKLE. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman, and welcome.

Let me see if I can get a reaction from you to this statement, and you are free to change the statement:

> Because transfer prices are often not measured at arm's-length prices, the Commerce Department's measure of exports and imports, and therefore the trade balance might be biased.

Ms. McLENNAN. The price of an export or an import is the price in the marketplace.

Mr. McGRATH. Let me rephrase it.

Ms. McLENNAN. The transfer price is something that is internal to a company, and the price that you or I would pay would be something that includes the transfer price, plus whatever——

Mr. McGRATH. Let me give you another chance at it.

How might our data on the trade balance be skewed by inaccurate transfer prices reported to you by multinational corporations?

Ms. McLENNAN. Well, I think Mr. Sailer could deal with that, for our information comes from the Bureau of Economic Analysis. Companies with foreign subsidiaries are surveyed, and they provide us with income statement and balance sheet information from which the tables in my testimony are drawn.

I understand that the Treasury Department also provided you with information based on the same data. As far as we know, this is accurate information, and it's based on prices within the marketplace.

Transfer pricing within a firm is not something that the Commerce Department has use of, or access to, except within the Import Administration's antidumping investigations.

I don't really deal with it.

Mr. SAILER. Well, I don't really deal with precisely the subject area that you have addressed, either, but it seems to me that really your question is a rhetorical one.

If transfer——

Mr. McGRATH. I cannot answer it myself.

Mr. SAILER. If transfer prices are used to reflect the balance of payments, the export values and the import values, then obviously there is the potential that those prices are not fair value prices, that the data may be skewed.

Mr. McGRATH. Just one further question.

If you found that some other agency in Government fell upon a scheme which might present an antidumping case, could you initiate that on your own, or do you need a complainant?

Mr. SAILER. We have the authority to initiate antidumping duty cases on our own.

It's a little more difficult than just answering that question "yes, we would" or "no, we wouldn't" because even as we would with a case that is brought to us by industry, we would have to discuss the issue with industry in the United States before we went forward.

Mr. McGRATH. But if another investigative agency of the Government stumbled upon it in the course of another investigation, would you feel that you could go forward with your own case or would you still want to talk to the industry and then see if you can get a complainant out of it?

Mr. SAILER. There are a lot of factors that go into determining whether or not to initiate an antidumping case, and I suspect that there are not too many agencies out there doing any kind of an investigation that could come up with all of the criteria required for us to do that.

Chairman PICKLE. I wish to inquire of you briefly about your coordination with other agencies. Now, under antidumping rules and problems related to it, the Department of Commerce, will initiate an investigation, whether there has been any dumping activity; is that correct?

Mr. SAILER. If U.S. industry comes to us and files a complaint alleging——

Chairman PICKLE. All right.

Do you do that only if a U.S. industry comes to you and says, we have been damaged?

Mr. SAILER. Well, as I said earlier, we do have the authority to initiate on our own.

Chairman PICKLE. Well, you have authority, but you normally do not do it. You act obviously when some company says we have been damaged and we ask you to look into it. That is normally the procedure, isn't it?

Mr. SAILER. That is right.

Chairman PICKLE. And when you do that, you look into it to see then if there has been damage to an American company; is that correct?

Mr. SAILER. We do not, but an agency of the Government does.

Chairman PICKLE. I cannot hear you. I am sorry.

Mr. SAILER. Yes. An injury analysis is conducted, but that is conducted not by the Commerce Department but by the International Trade Commission.

Chairman PICKLE. Well, I am sorry. I don't quite understand your response.

Mr. SAILER. In an antidumping case, a typical case follows two tracks. The Commerce Department conducts the pricing survey basically to determine whether or not prices to the United States are lower than in the home market.

On a separate track, the International Trade Commission will conduct an investigation of the U.S. industry to determine whether or not damage or injury has occurred.

Chairman PICKLE. If there is damage alleged, or if an investigation is undertaken and it shows that damage has occurred, then do you issue some kind of an order or enforcement procedure that carries out or corrects the damage?

Mr. SAILER. Yes, we do.

Mr. SAILER. There is a preliminary thing that occurs and then a final thing that occurs. If we preliminarily determine, about halfway through the investigation, that based on information we have received, it appears that there is dumping, we suspend the liquidation of entries.

That is, merchandise coming into the United States does not pay duties at that time, but the merchandise is held by Customs, at least the paper work on it, for the later payment of antidumping duties.

And the importer is required to post a bond to cover the amount of what we have found to be the dumping. And then ultimately at the end of the case we issue an order which requires cash deposits, the importer actually has to post money.

Chairman PICKLE. You issue an order.

Mr. SAILER. Right.

Chairman PICKLE. Or an order, in effect, I guess, an enforcement order, to try to make these corrections, and I assume from what you said, you give that, or you issue that to the Customs Office and for Customs to go out and make the corrections or to establish the damage?

Mr. SAILER. Well, the Commerce Department basically conducts an entry-of-merchandise by entry-of-merchandise analysis of what the actual dumping is.

And we instruct the Customs Service because they are the ones who collect money.

Chairman PICKLE. Customs carries that out?

Mr. SAILER. That is exactly right.

Chairman PICKLE. How many in the year 1987 or 1988, how many of these enforcement orders have you actually issued?

Do you have any idea? How often does that take place?

Mr. SAILER. In 1988, I believe we issued approximately 60 antidumping orders.

Chairman PICKLE. I cannot hear you. How many?

Mr. SAILER. Approximately 60.

Chairman PICKLE. Sixty?

Mr. SAILER. Yes.

Chairman PICKLE. In other words, that means that at least 60 companies did complain that they had been damaged; is that what that means?

Mr. SAILER. Well, it means that 60 industries producing a certain type of merchandise complained and were successful.

Chairman PICKLE. Now, when you issue those and you tell Customs to go out and make corrections, is that information passed on to the Internal Revenue Service?

Mr. SAILER. No, it's not.

Chairman PICKLE. And why not?

Mr. SAILER. I don't know that that information would——

Chairman PICKLE. Ms. McLennan, would you mention why it isn't?

Ms. MCLENNAN. Well, I believe that some of the materials put together by Import Administration would be very helpful to the IRS when they are doing the preliminary investigation. But I understand that the disclosure laws are somewhat different, and I am not sure materials from Import Administration are freely available to other agencies.

Chairman PICKLE. What kind of disclosure law would prevent you from doing that?

Mr. SAILER. If I may, Mr. Chairman, let me back up a little bit. As I mentioned in my testimony, we do collect on a very few occasions for very explicit purposes some transfer pricing information.

As I understand it, there may be some interest that that information be provided to the IRS. The disclosure laws are several. In the GATT, we have agreed as part of the international trading rules that in collecting information to conduct antidumping investigations, except for very discrete purposes and to very discrete identifiable parities, the information will not be disclosed.

The Congress in 1979 adopted the GATT language at that time, which has been carried through to today, which specifically restricts the Commerce Department from disclosing business proprietary data it receives from anyone other than parties to the case, the Customs Service——

Chairman PICKLE. All right.

Then you are saying that you don't disclose this information to the Internal Revenue Service, primarily because you might disclose some proprietary interest in the product involved?

Mr. SAILER. Proprietary interest of the producer that provided us with the information, yes.

Chairman PICKLE. All right. Now, if this enforcement order is issued and you are trying to establish it, either through your action or through the Customs Office, if you pursue it correctly and to its conclusion, you would establish what would be the production costs involved in a particular product, wouldn't you?

Mr. SAILER. In some cases.

Chairman PICKLE. Well, in most cases, probably; wouldn't you?

Mr. SAILER. Well, I couldn't tell you right off the top of my head the exact number, but actually the statute indicates to us that we should prefer, and we do, to make price-to-price comparisons. So——

Chairman PICKLE. You establish the production cost of its origination, it's home country, and——

Mr. SAILER. In some cases.

Chairman PICKLE. And by product lines, too, because the real purpose of the investigation is to see if somebody has been damaged, isn't it?

Mr. SAILER. Well——

Chairman PICKLE. You are trying to establish cost production, and therefore you get information in the questionnaire that should be passed on to the Internal Revenue to determine whether somebody——

Mr. SAILER. Well, as I said, in some cases we may have some information that the Internal Revenue Service might think is relevant.

Again, that really is in the minority of cases, I believe, and as I mentioned, and I think as Ms. McLennan went on to say, we are conducting an antidumping investigation, obtaining information that is massaged in a certain way that does not necessarily meet the standard of what is required in section 482.

Chairman PICKLE. Well, I don't know whether—what I am trying to derive is what is the importance of the so-called questionnaire that companies, which are under investigation, must complete and file with the Commerce Department?

Obviously, the answer is that it contains a breakdown on production costs; does it not?

Mr. SAILER. Well, sometimes. It requests four different things. There are four sections to the typical questionnaire. One section requests general information on a company and its marketing and sales efforts, both in the home market and in the United States, and in third countries.

Mr. SAILER. The fourth section, which is only brought into those cases where constructed value must be used, that is, there is a reason why we cannot use home market prices——

Chairman PICKLE. I asked the question of you, why shouldn't a Federal agency like the Internal Revenue Service have the benefit of the data that you gain from these questionnaires?

It has basic production costs that would be helpful to them. Why do you oppose it?

And I assume the only reason you oppose it is because it might disclose some proprietary interest involved. Is that essentially what you are saying to me?

Mr. SAILER. In the small number of cases where we would actually have production costs where we would have transfer price information that might be of some interest to the IRS, we oppose—we oppose the fact that we might have to provide that information to the Internal Revenue Service because the United States has agreed in the General Agreement on Tariffs and Trade with all of our trading partners that we will not disclose that information, except to certain parties.

And in the U.S. legislation which implemented the GATT in 1979, the U.S. legislation specifically spells out who may and under what circumstances they may receive the information.

And we have legal memorandums from our general counsel, with which the Treasury Department has agreed, that the information cannot be released beyond the confines of the specified parties.

Chairman PICKLE. I don't want to say that Commerce is hiding behind this provision just so they can protect proprietary interests. It seems to me though then that Federal agencies are not talking to each other, either Commerce or Customs.

Customs, in effect, say they report very little to the Internal Revenue Service. All of this is very complicated, but it's also very related and this committee, I hope, will find some way to bring about better coordination because you just cannot say you talk only to God and God only to somebody else.

Mr. SAILER. I will say this, on a day-to-day basis, we have a fairly close liaison with the Customs Service. As I understand it, it has been only on the very most remote—in the most remote cases that the IRS has even asked for information.

Chairman PICKLE. The Chair recognizes Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman. Let me ask you, Mr. Sailer, did I understand you to say that you said that no one else could get that information? I thought that Customs could get that information.

Mr. SAILER. Well, I said that no one other than those individuals specified in the U.S. law—the U.S. law prohibits us from disclosing proprietary data which is provided to us, except as specified in that law.

Among those who may receive it are parties to the case, the foreign parties, the U.S. industry. They may receive it under administrative protective orders.

Mr. FLIPPO. But you share this with Customs.

Mr. SAILER. We may provide it to the Customs Office.

Mr. FLIPPO. Which is also a division of Treasury, right?

Mr. SAILER. Yes. They are specified in the statute.

Now, the information that we provide to Customs on a day-to-day basis is not even——

Mr. FLIPPO. I see. OK.

Mrs. McLennan, you formerly worked as an industry economist for the IRS, I believe, did you not?

Ms. MCLENNAN. That is right.

Mr. FLIPPO. Would you share some of your observations with the subcommittee that you learned from your unique opportunity to observe the Japanese cultural and trade practices in regard to 482?

I guess what I am interested in determining is whether or not you believe that there are enforcement problems with section 482, pricing cases, and what specific problems did you observe as an economist?

Ms. MCLENNAN. Well, I am sorry I cannot comment on the testimony the committee heard on Tuesday because as a matter of fact, I was coming back from Japan on that day.

The Service faces very substantial enforcement problems because of what I would say is a lack of personnel who are capable of doing large research studies.

There are also problems even if you do get a decent piece of research with respect to a specific firm. What you are talking about is a team of, say, your individual industry economists that do the research, plus the district office which consists of your auditors and examiners. Then you have your legal staff that has to understand what the research consists of and what the auditors have done with the research. Then that has to be moved through an appeals process which is really tortuous and difficult. Now, I am sure you heard more in detail about these matters from the people that are currently with the Service than you need to know from me.

I have to say that in my experience with the Service, I was able to do some very successful research.

I was given an opportunity to create the research design by myself with colleagues that were very experienced in the area. I did one study that fit four companies in a particular industry, and the study was used in all four cases, which made it more efficient.

I also have to say that I am very highly trained to do this. I have both the law degree and a Ph.D. and a substantial research record, and I don't know if other people would have done it the same way that I did.

In conjunction with the research, though, you have to have a feeling that someone is going to use it to effect—and I had a very good team in the Laguna Nigel district that stayed together for the duration of these particular cases.

So maybe I have the most fortunate experience possible within the IRS and possibly no one else may have been able to do that. But let me tell you this. I had to collect information on a great number of firms from very difficult sources. For 23 companies I entered all the data on a little computer by myself. I took the computer home with me because there was no one in the office to do that.

We are talking about a situation where there is absolutely zero secretarial assistance, absolutely nobody, where the agents are doing everything, almost the way they would have done it a hundred years ago.

The only difference is they are not using quill pens. They are doing it on a typewriter. And for this kind of situation to go into court opposite firms that are capable of hiring and having almost unlimited support for them you know, you are really talking about a very small agency up against very, very large competitors in the marketplace.

But having said that, I think we were very successful. Many of the cases that I worked on were settled to the satisfaction of the Service.

Now, I am not sure I have answered your question. I don't want to zero in on the Japanese because let me say to you, in 4 years with the IRS, the Japanese taxpayers were not the most abusive taxpayers that I saw.

Chairman PICKLE. Will the gentleman yield?

Mr. FLIPPO. Sure. Absolutely.

Chairman PICKLE. When you say that most cases you worked on had been successful, are you talking about in your prior life when you were with the Internal Revenue Service?

Ms. MCLENNAN. Right.

Chairman PICKLE. Or when you were with Commerce now?

Ms. MCLENNAN. Now I am with Commerce.

The question was about——

Chairman PICKLE. Let me ask you——

Ms. MCLENNAN. I hesitate to get into that because I don't want to start identifying particular cases.

Chairman PICKLE. You worked in both areas. It has been contended that the IRS is outgunned and outmanned. Is that essentially correct?

Ms. MCLENNAN. Yes. I think if you go to Tax Court, you could see the number of people on both sides.

Chairman PICKLE. They are short of economists, short of tax experts.

Ms. McLENNAN. Short of everything.

Chairman PICKLE. Short of employees of an expert nature.

Ms. McLENNAN. They have one advantage——

Chairman PICKLE. Do Appeals officers settle cases for less on the dollar than they should in your judgment?

Ms. McLENNAN. Many of the Appeals officers are very inexperienced in international regulations. It is well known that they would settle a case without even looking at the issue.

In my particular case—I think I could say one or two times that this happened over the whole 4 years that I was with the Service.

Chairman PICKLE. What has happened only one?

Ms. McLENNAN. That the Appeals officers settled for less.

Chairman PICKLE. You are saying the field examiner basically got the best settlement and did a good job on these tax cases?

Ms. McLENNAN. Most of the cases on which I worked ended up in court or close to being in court.

Chairman PICKLE. Have you ever had the IRS indicate to you that they wanted you to close a case and get on with it because it is difficult to settle?

Ms. McLENNAN. That never happened to me.

Chairman PICKLE. I understand. This seems rather difficult to proceed on because I understood that you or somebody in your division had referred to the IRS agents and to the Appeals people as "men in the little red suits" meaning they were Santa Clauses.

Now, you tell me they are doing a great job. Are they little men in red suits who have pitchforks on their heads or Santa Claus?

Ms. McLENNAN. In terms of the cases I personally worked on this did not happen but I knew many agents who told me stories about what happened to their cases and I understand from them that this was a very common problem. I came very close to seeing that myself.

Chairman PICKLE. We will look into this further because you have instances where IRS agents themselves said they were outgunned; second, that they have been under pressure; third, that they have settled for at best 33 cents on the dollar and I am saying, how can you as a former employee say that they have only misjudged a case once in a hundred cases.

It seems to me you have gone 180 degrees in your statement. What is your position? Are you happy about what the IRS is doing?

Ms. McLENNAN. The reason I couldn't answer that is because most of my cases were never even into appeals. It took the IRS so long to complete the cases they were never submitted to Appeals officers.

Let me add I was only with the IRS for 3½ years, which is a relatively short period of time. You would be better off talking to someone who has been with the service 10 or 15 years.

Chairman PICKLE. I agree. We might be better off getting that answer from someone else.

I am concerned there is an appearance you might be trying to protect the system. We are trying to get facts and if the facts should be told to us, I wish you would make that plain.

Ms. McLENNAN. It is widely stated throughout the IRS that the appeals level does give away cases at much less than what was worked at the district level. This is widely believed.

In my experience, 50 percent of what the district wants is what the Appeals officer tries to get. But that did not happen to me personally in the cases that I worked on.

Mr. FLIPPO [presiding]. Were there other impressions you would care to share with us with regard to the ability of opposing attorneys to influence the outcome of cases?

Ms. McLENNAN. Well, I am not sure. Again, this is by rumor and not based on my personal experience, but it was widely discussed with respect to one set of cases on which I worked that the opposing attorney attempted to influence people within the Government, within the senior levels of the Department, to close down cases.

But again, I can't speak to that directly and it is my understanding that something of that nature takes place every now and then.

The fact is if you go into Tax Court, the Service attorney will be up against one of the best or top tax lawyers in the country supported by one of the big eight accounting firms or major consultants providing the backup.

They can be very, very impressive compared to what a small district with one economist within the IRS and no support staff can do.

Mr. FLIPPO. Here you seem to be addressing the professional competence issues but we were talking about undue influence or something that is not related necessarily to ability.

Was there a general impression that existed on all sides that the company's attorneys could and did influence the outcome of cases through friendly access to senior officials?

Ms. McLENNAN. I can't say that is a general statement.

Mr. FLIPPO. Thank you.

Ms. McLENNAN. It happened once or twice over the 4 years that I was there.

Can I address the question of competence also? It is widely said that the high-priced attorney or accountant or economist is going to be more competent. That is not necessarily the case.

I have seen very, very good research done within the IRS with very little resources.

Mr. FLIPPO. All I was trying to ascertain was from your personal experience, if you saw anything out of the way in that area.

Ms. McLENNAN. Well, within my team it was more visible to other members of my team than to me, but I heard about it.

Mr. McGRATH. Would the gentleman yield?

You were cut off on two occasions when you were about to say something. At one time you were talking about the advantages that outside attorneys had in trying some of these cases. But you were about to say, but the IRS has one advantage. What is that advantage?

Ms. McLENNAN. Well, the best advantage a good researcher can have is time to complete the work within the framework set, and without interference during the conduct of the research. A well-designed project carried out according to the norms that are established by academia or the research community is going to be a much better piece of work at the end, than something dictated by someone who paid for the research. That shows up when it comes to a discussion in court.

Mr. **McGrath**. Then you were referring——

Ms. **McLennan**. Let me complete that. I must have been unusual because I was allowed to work on an industry study for several years without interference. The district did not push me to finish it.

I had heard while I was with the IRS that other districts might have pushed you to finish within a certain period of time because they were anxious to complete cases by a set calendar. That never happened to me within that timeframe that I had, I was able to complete the study.

Mr. **McGrath**. You said at one time in answer to a question that the Japanese taxpayers were not the most abusive. You were about to say who was——

Ms. **McLennan**. No, I wasn't going to identify them. I would say that by nationality, the Japanese are not necessarily the worst taxpayers in this country. I had worse results with European companies. We are talking about a very small sample of cases and very individualized situations. In my situation, the Europeans were a little bit more greedy than the Japanese.

Mr. **Flippo**. Thank you.

Chairman **Pickle**. I thank you both very much for your testimony. We have a lot of other questions, but we have another panel.

We will submit those to you and ask you to respond to us in writing if you can.

Thank you very much.

Now, the Chair asks the next panel to come forward: Michael Granfield, James Wheeler, Lawrence Gibbs, and Roscoe Egger.

Michael Granfield is associate chancellor academic, University of California, Los Angeles. Dr. James Wheeler is professor of accounting, University of Michigan.

Our old friend Mr. Lawrence Gibbs, former Commissioner of Internal Revenue Service, and a good one. We are glad to have you back with us.

We likewise have another outstanding Commissioner who was with the IRS for many years, former Commissioner Roscoe Egger.

Mr. Gibbs, we will ask you to proceed first and then Mr. Egger.

STATEMENT OF LAWRENCE B. GIBBS, PARTNER, JOHNSON & GIBBS, FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. **Gibbs**. Thank you, Mr. Chairman, Mr. Flippo, Mr. McGrath, I am pleased to be here today to testify concerning the compliance by the multinational businesses with the transfer pricing provisions of section 482 of our code. During my tenure as Commissioner of the IRS, I met periodically with my counterparts from various foreign countries to discuss tax compliance issues arising from the activities of multinational businesses, and I was involved in the preparation and publication of the so-called section 482 white paper.

In returning to the private practice of law, I now represent U.S. and foreign-based multinational business, and you should know that some of them are involved in audits by the IRS that do raise transfer pricing issues under section 482. Recently I have begun visits to several foreign countries to meet with tax practitioners, tax administrators and business representatives to discuss U.S. policies and practices in administering section 482 of the code.

I would like to turn to page 4 in my written testimony to discuss the administrative recommendations that I would like to suggest in this area. First, as we have heard earlier today and also day before yesterday, I would urge that more resources be devoted to the international taxpayer assistance and compliance areas, but I would suggest that they be targeted. I would target them to more studies and projects to determine potential areas of noncompliance and because of the level of complexity and difficulty of the transfer pricing issues in section 482, I would target the resources and encourage the Internal Revenue Service to develop better inhouse expertise and to use more outside experts at the examination level.

I think it is both important and difficult for the IRS auditors to know what type of factual information to develop in transfer pricing areas unless they have the assistance of experts. This is a very difficult and complex area, as you know and have been told, and IRS must have the experts beside the auditors at the time they begin the audits in order to effectively get to the issues that need to be raised in the audits.

Chairman PICKLE. This morning the Assistant Secretary of Treasury indicated that they would agree with that position.

Mr. GIBBS. I would also add that where necessary, the IRS should use its attorneys and technical experts in the national office to assist the agents in the field in connection with these cases.

I would like to suggest, however, that the IRS should be sensitive to the need for confidentiality of both trade secrets and other business tax information of taxpayers, both foreign and domestic. For example—and this surprised me when I found out recently—that the statutory civil and criminal sanctions for disclosure of tax information that are applicable to IRS officers and employees apparently do not apply to expert consultants that are employed by IRS and provided with the confidential information. The IRS attempts to remedy this by contract with the consultants, but I urge that IRS, Treasury and Congress focus on this omission and consider providing suitable sanctions for disclosure of confidential tax information in the hands of expert consultants who are employed by IRS.

I would like to move to page 7 to discuss the litigation aspects of these cases because I believe there is likely to be increased litigation of section 482 cases and I urge that IRS Chief Counsel and the Tax Court begin focusing on ways to handle these cases as expeditiously and cost effectively as possible.

These cases are going to be very complex factually and they entail time-consuming and expensive development in what is inherently a valuation-type issue.

My final administrative recommendation is to say that I believe the advance determination approach recently suggested by IRS is a step in the right direction. I would encourage the Service to consider whether a similar approach with respect to prior years, possibly through settlement guidelines and closing agreement procedures, might also be used to dispose of the pending cases in appropriate circumstances. I suspect, however, that dealing with the past will be much more difficult than dealing with the future.

Turning to legislative recommendations, with respect to the question that has been raised several times about do we need something in addition to or in lieu of section 482, I don't know whether extensive legislative changes are necessary, and if you were to press me, I don't know what I would suggest and I would like to explain why.

First, the IRS studies clearly suggest tax avoidance in specific industries in certain instances. I would like to pause to compliment the staff of this subcommittee and the presentation that was made by the Internal Revenue Service day before yesterday. I think the point has been made, and made well, that there is noncompliance in the section 482 area.

I was interested in the Joint Committee on Taxation pamphlet which suggests that this is largely because of lower tax rates in other countries and higher tax rates in the United States. The reason this struck me as interesting is that in 1986 the United States lowered its marginal corporate tax rates, and it is my understanding that most of the IRS cases are pre-1986. I simply submit that if the issue is lower effective rates in other countries, it would be interesting to know what the effects would be post-1986 in terms of attempting to determine whether more legislation would be appropriate.

Also, as has been mentioned, in 1986 Congress amended section 482 to add the super royalty provisions which are discussed on pages 13 and 14 of my testimony. It has been suggested that these provisions in the context of a U.S.-based multinational business are overly protective of U.S. revenues and adversely impact the revenues of other countries. But I would ask; what about the foreign-based multinational who wishes to take advantage of the super royalty provisions when they export goods and technology to the United States? Will the reverse be true? Will the result be that in transfer pricing cases involving foreign-based multinationals that the super royalty provisions in effect will steal from U.S. revenues and enhance the revenues of other countries? I don't know the answer, but it seems to me that before we begin changing the law, we ought to know what the ramifications are in light of the fact that you have the inbound and outbound transfers.

In any event, responsibie individuals are beginning to question the fairness of our international tax laws, including section 482, as indicated in the discussion on page 9 of my testimony. Should we take an overall look at foreign tax policy, possibly beginning with section 482? Again, I don't know the answer to these questions, but I believe that the concerns are legitimate and the questions are fair, and I would urge the subcommittee to do two things in response.

First, I would urge you to consider establishing a roundtable once again. We have heard blue ribbon committees and that type of thing. This subcommittee has done a very good job of assembling roundtables of individuals from IRS, Treasury, our treaty partners, possible representatives of U.S. and foreign-based multinational and others with backgrounds and interest in these very difficult and important issues. The point that I would make is that this hearing—these 2 days of hearings—have raised very good questions and they have provided a lot of information. I think there needs to be time to assimilate and to have an appropriate response made before you can really answer some of the questions that you are asking.

The second and last recommendation I would make is that this subcommittee or the tax-writing committees, whatever is appropriate, should consider establishing liaison relationships with your counterparts in legislatures of other countries to discuss these issues. There is a need to harmonize our tax laws with those of other countries. Business, tax representatives and tax administrators are meeting with their counterparts in other countries, and I ask, why shouldn't you? My answer is: I think you should. I would urge you to establish those liaison relationships and recognize that what you do in this area is likely to be the pattern for what is done in other countries that will affect our multinational taxpayers based in this country.

Mr. FLIPPO. Thank you, Mr. Gibbs. Outstanding testimony.

[The prepared statement follows:]

TESTIMONY OF LAWRENCE B. GIBBS

BEFORE THE SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

REGARDING COMPLIANCE BY MULTINATIONAL BUSINESSES

WITH THE TRANSFER PRICING PROVISIONS OF SECTION 482

OF THE INTERNAL REVENUE CODE

JULY 12, 1990

Mr. Chairman, I am pleased to be here today to testify regarding compliance by multinational businesses with the transfer pricing provisions of Section 482 of the Internal Revenue Code. During my tenure as Commissioner of IRS I met periodically with my counterparts from various foreign countries to discuss tax compliance issues arising from the activities of multinational businesses, and I was involved in the preparation and publication of the so-called "Section 482 White Paper." In returning to the private practice of law, I now represent U.S. and foreign-based multinational businesses, some of which are involved in audits by the Internal Revenue Service that raise transfer pricing issues under Section 482. Recently I have begun visits to several foreign countries to meet with tax practitioners, tax administrators, and business representatives to discuss United States policies and practices in administering Section 482 of the Code.

Based on all these experiences, it is apparent to me, as I am sure you have discovered from these hearings, that the transfer pricing topic is complex. It involves the entire spectrum of international relations, tax and economic policies. There is no simple solution.

THE GLOBAL BUSINESS COMMUNITY

After World War II many American businesses expanded their activities on a worldwide basis. More recently businesses in other countries have become competitive in worldwide markets, and particularly in U.S. markets.

The pace of globalization is accelerating. We are all aware of increased international competition in certain manufacturing areas (for example, the automobile and electronics industries) and in the financial areas, as indicated by 24-hour securities trading and worldwide lending activities. Accounting and law firms are establishing international relationships. Foreign competition has increased at our local levels, and more United States businesses are engaged in foreign operations and activities. From a United States perspective, it is important to recognize that this phenomenon is no longer limited to a handful of industries in a small number of large cities. The fact (and impact) of globalization is being experienced on a widespread basis across our country.

INCREASED INTERNATIONAL TAX EMPHASIS AT IRS

This internationalization of the business community is reflected in the changes and increasing complexity in the international tax provisions of our Federal income tax law over the last ten years. It is also reflected in the changes that have occurred at IRS during the last decade. The biggest single change at IRS that I noticed when I returned as Commissioner in 1986 was the growth and importance of the international area. The establishment several years before my return of the office of the Assistant Commissioner (International), with its counterpart in the Chief Counsel's office, reflects the increased emphasis at IRS on international tax matters. While I was Commissioner I met at least annually with my counterparts in the United Kingdom, France, and Germany (the so-called Group of Four) and my counterparts in Central and South America (the so-called CIAT Organization). I also found that IRS had extensive contacts with other tax administrations around the world and an active program to provide technical and other assistance to these developing countries.

The impact of the 1986 Tax Reform Act changes in the foreign area occupied much of my time with rulings and regulations, as did the Section 482 White Paper and various joint tax administration projects with my counterparts in other countries. In coping with the increased sophistication of worldwide business transactions and international tax avoidance or evasion schemes, my counterparts and I resolved to try to avoid taxing income twice, but to attempt to tax income at least once somewhere in the world.

IRS ADMINISTRATIVE RECOMMENDATIONS

The competent authority settlement with the Japanese automobile manufacturers that occurred while I was Commissioner is well-known. Less well-known -- at least until this hearing-- were IRS projects analyzing levels of compliance by United States subsidiaries of foreign-owned businesses in the electronic, motorcycle and other industries. I urge that more resources be devoted to the international taxpayer assistance and compliance areas. I endorse more IRS studies and projects to determine potential areas of non-compliance with our tax laws.

Because of the level of complexity and difficulty of the transfer pricing issues in Section 482, I encourage IRS to develop better in-house expertise and/or greater use of outside experts at the Examination level. It is difficult for IRS auditors to know what type of factual information to develop in the transfer pricing area without the assistance of experts to analyze the business functions being performed in the United States and abroad, as well as the role and importance of intangibles and technology being used in the United States and abroad. Where necessary, IRS should use its attorneys and technical experts in the National Office to assist agents in the field in dealing with difficult procedural, proof, and technical tax issues that arise in connection with Section 482 examinations.

However, if IRS is going to use these additional resources, I also believe it is incumbent upon IRS to use them wisely and well. In particular, IRS should be sensitive to the need for confidentiality to protect trade secrets and other business tax information of taxpayers (both foreign and domestic). For example, statutory civil and criminal sanctions for disclosure of tax information that are applicable to IRS officers and employees apparently do not apply to expert consultants employed by IRS. See Limitation on Redisclosure By Contractors, IRS Manual (21.40(1)-(4) (May 29, 1984). IRS, Treasury, and Congress should focus on this omission and provide suitable sanctions for disclosure of confidential tax information in the hands of expert consultants who are employed by IRS.

If IRS involves attorneys at the Examination level, IRS should articulate the role of these attorneys and the circumstances under which taxpayers and their representatives may contact and discuss issues with the IRS attorneys. If the IRS attorneys and technical personnel (whether in the field or the National Office) are going to be involved in the analysis and decisionmaking with respect to technical and procedural issues, then taxpayers and their representatives should have access and the opportunity to have discussions with the IRS attorneys and technical personnel before final decisions are made. Otherwise, I am concerned that the Examination process is likely to become even more adversarial and time consuming.

Similarly, if IRS attorneys are to be involved during the Examination stage, then careful thought should be given to the role of the Appeals Division, and particularly whether it will continue to act (and be perceived by taxpayers and their representatives as acting) as a wholly independent level of review. To the extent that IRS attorneys in the field actively participate in the legal and technical preparation of the case at the Examination level, taxpayers and their representatives may become skeptical and concerned about the continuing independence of Appeals, particularly since field attorneys continue to have direct supervision of Appeals. I recognize the distinction between Regional Counsel attorneys and District Counsel attorneys, but taxpayers are likely to question the independence of Appeals unless IRS articulates the roles of the various attorney offices and Appeals in such a way that the continuing independence of Appeals is credible.

It is unlikely that increased litigation of Section 482 issues will be a satisfactory solution for the disposition of transfer pricing cases. These cases tend to be very complex factually, and they entail time consuming and expensive development of what are inherently valuation types of issues. Because of the potentially substantial amount of tax involved in Section 482 cases, often the Tax Court will be selected as the forum for litigation. Historically, cases involving valuation type issues demonstrate the difficulty of resolving such cases on a volume basis by litigation, particularly litigation in the Tax Court.

As IRS devotes more resources to transfer pricing cases, I predict that the Tax Court's docket with respect to these cases will increase substantially. I also predict that, in such event, the Tax Court will have difficulty in disposing of these cases in a timely fashion, particularly if their volume become substantial. Unlike tax shelter cases, it will be difficult to dispose of a number of Section 482 cases by consolidation and test cases.

I believe the advance determination approach recently suggested by IRS is a step in the right direction. I encourage IRS to consider whether a similar approach with respect to prior years, possibly through settlement guidelines and closing agreement procedures, might also be used to dispose of pending cases for past years. I suspect, however, that dealing with the past will be more difficult than dealing with the future.

LEGISLATIVE RECOMMENDATIONS

IRS and multinational businesses (whether U.S. or foreign-based) will continue to have substantial difficulty in resolving transfer pricing problems on the basis of Section 482 as it is presently written. I will be frank to admit that at this point I do not have a better alternative to offer. However, I would like to suggest an approach to identify and evaluate alternatives.

The present tax policy objectives in the transfer pricing area are based upon a desire to ensure compliance with U.S. tax laws, which means an assurance that multinational businesses (whether U.S. or foreign-based) pay their "fair share" of tax to IRS. In the context of transfer pricing, this presumably entails finding a way fairly to allocate net taxable income among the various sovereign tax jurisdictions to which the multinational businesses may be subject.

In order to avoid competitive disadvantages to either U.S. or to foreign-based multinational businesses, I also assume -- as Section 482 assumes -- that the same rules should be applicable to inbound and outbound transfers of goods, services or technology. However, responsible tax practitioners recently have questioned whether the same rules are applicable and being applied to inbound and outbound transactions. The attached article by Mr. Yuji Gomi, former Deputy Commissioner for International Tax Affairs of the National Tax Administration in Japan, expresses concerns that there is a disparity in the U.S. tax treatment of inbound and outbound transfers, which may be prompted by desires to address U.S. budget deficit objectives at the risk of provoking international retaliation. Similar concerns have been expressed by a former Treasury Department international tax attorney. Stanford G. Ross, "U.S. International Tax Policy: Where Are We Going? Where Should We Be Going?" 47 Tax Notes 331, 335-36 (April 16, 1990).

In order to determine whether the policy objectives of Section 482 are being served in a reasonable manner, the Subcommittee wisely has begun an evaluation of a variety of tax, economic and other business-related information. In light of the information provided by these hearings and the disparity of views about what the information may mean, I urge the Subcommittee to provide the opportunity and means for analysis and discussion by interested parties about the magnitude and reasons for non-compliance with the provisions of Section 482 by foreign-based multinational businesses and suggestions about what should be done.

Based on the pamphlet prepared for this hearing by the Staff of the Joint Committee on Taxation, it appears that the relationship of effective tax rates is believed to be of paramount importance. Indeed, the pamphlet suggests that multinational businesses may plan their transfer pricing arrangements by comparing the effective tax rates of the tax jurisdictions to which they are subject, and then arrange their transfer prices so that the bulk of their income is taxed at the lowest effective rate. Perhaps this is so. Certainly, based on testimony day-before-yesterday by the Staff of the Oversight Subcommittee and IRS representatives, it appears that some multinational taxpayers in the past have taken this approach. However, I am unaware of any comprehensive study of multinational taxpayers (U.S. and foreign-based) that supports this conclusion.

I assume that any such study would have to be pursued on an industry-by-industry basis, and would have to include a comparison of pre-1986 and post-1986 transfer pricing arrangements. In the United States different industries have different effective tax rates, depending upon the extent to which the federal income tax laws subsidize the particular industry. Presumably, the same would be true in other countries. Any study would have to compare tax policies in various taxing jurisdictions on an industry-by-industry basis.

The 1986 Act made substantial changes in the effective tax rates of corporations. Generally, the 1986 Act increased the effective corporate income tax rates, although in some instances effective corporate tax rates were decreased because of the decrease in the marginal corporate tax rate. Therefore, it would be important for any such study to compare effective tax rates for multinational corporate businesses before and after the 1986 Act.

If it is determined that foreign-based multinational businesses have a measurably lower effective U.S. tax rate in certain industries, then it will be necessary to determine why there is this variance. One possibility is that foreign-based multinational businesses as a group have systematically engaged in efforts to avoid U.S. tax by allocating a disproportionately lower amount of income to their United States activities. Again, I am not aware of any study or other determination that would support such a conclusion. For the most part the foreign-based multinational businesses doing business in the United States are likely to be major corporations based in other high-tax countries with which the United States has long-standing treaty relationships. It therefore seems unlikely that such corporations as a group would undertake a systematic effort to intentionally avoid U.S. tax obligations. The industry-by-industry comparison of effective tax rates in various countries discussed above might be helpful in shedding light on this possible explanation.

A second possible explanation for any variation might be that the foreign-based multinational businesses may have been engaged for many years in broad market development activities in the United States, which could have resulted in significantly higher cost and expense levels than had been experienced by their United States competitors who have enjoyed market dominance based on mature investments.

A third explanation may relate to the amount of debt involved in capitalizing the United States subsidiary of the foreign-based multinational business. If the debt-to-equity ratio is substantial, then interest expenses are likely to reduce U.S. taxes and lower the effective U.S. tax rate. These considerations presumably prompted the addition of the so-called "earnings stripping" provisions of Section 163(j) in the legislation that was enacted by Congress last fall.

IMPACT OF U.S. INTERNATIONAL TAX POLICY ON TRANSFER PRICING

A fourth explanation may lie in the orientation of the international tax law and treaty policy of the United States. Our policy has been oriented primarily toward assuring adequate levels of U.S. tax on the exporting activities of U.S. based multinational businesses, with only minimal attention being given to the taxation of foreign-based multinational businesses importing goods and technology into the United States. When the relevant international tax provisions are then utilized in planning for a foreign-based multinational business that is transferring technology or goods manufactured abroad into the United States, they could have the opposite effect -- i.e., minimization of U.S. taxation.

While I have not undertaken to make an exhaustive analysis of this possible thesis, it seems clear that such a process has occurred with respect to the current policies under Section 482. The most recent Congressional review of this area was in connection with the 1986 Act, which enacted the so-called "super-royalty" provisions of Sections 482 and 367(d). The legislative history of the 1986 Act graphically states the concern of Congress that U.S. multinational businesses may have had significant incentives to export technology in a manner to minimize their U.S. tax liabilities. Thus, in the "Blue Book" of the 1986 Act, the Joint Committee on Taxation stated the reasons for the changes as follows:

> There was [under prior law] a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax

> jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.
>
> Congress was concerned that the provisions of. . . [the Code] that allocate income to a U.S. transferor of intangibles may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.
>
> The basic requirement of the [1986] Act is that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporations be commensurate with the income attributable to the intangible. This requirement is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each. Blue Book at 1013-15.

Pursuant to directives in the 1986 Act, the Treasury Department and IRS issued the "Section 482 White Paper" which suggested several methodologies for implementing the pertinent provisions of the 1986 Act. One of the principal suggestions in the White Paper was the so-called "basic arm's length return method," which would measure the return that should be earned by a certain function by the amount of capital committed to that function and the return that a third party would receive from the performance of such function.

The 1986 Act and the White Paper may provide an effective means of achieving the goals of the Congress with respect to certain perceived abuses by U.S. multinational businesses that export tangibles. They may also provide a regime of taxation that minimizes the U.S. tax liability of a foreign-based multinational business that exports goods and technology to the United States.

The Blue Book plainly states the Congressional intent that the "super royalty" provisions would apply to inbound as well as outbound transactions, since the objective of the provisions was to create a "division of income between related parties [that] reasonably reflect[s] the relative economic activity undertaken by each . . . ." Blue Book at 1016.

There appears to be a similar "outbound" orientation in the treaty policy of the United States. One could view our policy as traditionally favoring residence as opposed to source as a basis for taxation. This would be beneficial to our Fisc if the United States were viewed as an exporter of goods and technology. It might also provide significant planning opportunities for foreign-based multinational businesses that are in a position to export goods and technology to the United States.

The orientation of the U.S. tax law and treaty policy is an area that deserves further study by the Subcommittee, because it may well be that these policies are responsible for a significant portion of any measurable variance in the effective U.S. tax rates as between U.S. and foreign-based multinational businesses.

CONCLUSION

Mr. Chairman, I congratulate you and the other members of the Subcommittee in holding these hearings to begin the needed dialogue about the import of the present transfer pricing rules of Section 482. I have tried to spell out why I believe the issues are as complex and difficult as they are important. There is a need to harmonize the transfer pricing rules under Section 482, as they apply to both inbound transfers by foreign-owned companies and outbound transfers by U.S. owned companies. I also believe there is a further need to harmonize U.S. transfer pricing rules with those of other foreign countries. This is precisely what is happening today among the member countries of the European Community. Japan, too, recently has passed Section 482 type legislation. Unilateral changes in transfer prices of multinational companies by taxing authorities result in double taxation unless the changes can be resolved by the companies with the various sovereign taxing authorities.

I urge the Subcommittee to take a global approach in dealing with global issues such as transfer pricing under Section 482. This Subcommittee has previously developed effective tax policy in difficult areas where there are substantial disagreement between IRS and taxpayers by calling various parties together for roundtable discussions to develop a consensus for badly needed tax changes. The transfer pricing area may lend itself to this type of approach. By convening a roundtable made up of certain of our treaty partners, IRS representatives, and possibly representatives of foreign and U.S. based multinational businesses, this Subcommittee may be able to develop additional approaches that may be of help in this area.

In any event, I recommend that the Congressional tax-writing Committees consider establishing liaison relationships with legislative functions in the countries of our principal treaty partners to exchange information and views with respect to the issues of taxation of multinational businesses. Such exchange is occurring among tax administrators in these countries and also among members of the business and professional communities in the tax area. In the final analysis, in the global, economic and business community it is imperative that we harmonize the tax laws of the various taxing jurisdictions affecting, and being affected by, multinational businesses. It could be very beneficial to the Congressional tax-writing Committees and to this Subcommittee to establish these relationships.

OPINION

'Tax friction' with U.S. is next on horizon

By Yuji Gomi

Changes in the U.S. tax code do not prevent tax avoidance, but merely boost revenues at the expense of foreign corporations and governments.

In December of last year, the U.S. Congress adopted two provisions to strengthen the tax code as it applies to foreign-owned corporations in the U.S.

These measures, while well-intended, are likely to generate "tax friction" between the U.S. and countries with which it has concluded tax treaties.

One of the provisions limits the deduction of tax-exempt interest payments to parent companies and others overseas. The other stiffens reporting requirements for certain foreign-owned corporations. Both will take effect as of the first accounting period beginning after July 11, 1989. They will have a major impact on Japanese corporations.

Before adoption of the new provisions, corporate tax deductions were allowed for interest payments to overseas parent companies, even if these payments were not subject to taxation in the U.S.

This made it possible for foreign-owned subsidiaries to borrow heavily from their overseas parent, in amounts disproportionately high in relation to their paid-in capital.

In other words, by boosting their interest payments, subsidiaries were able to take advantage of tax treaty provisions which reduce or exempt taxation of interest, and thus hold down their U.S. corporate tax bills.

The limit on deductions was intended to cut off this form of tax avoidance.

When viewed from the perspective of international taxation, however, holding down tax payments in the U.S. is not necessarily the same as tax avoidance.

Even if tax-exempt interest payments are deductible in the U.S., for example, they are nevertheless subject to taxation in the home country of the corporation to which the payments were made.

Under the new tax provisions, however, if a foreign-owned subsidiary does not pay dividends to its parent in Japan, the taxation of interest will increase its corporate income tax burden in the U.S.

If dividends are paid, however, provisions to prevent double taxation across borders would result in a reduction of Japanese corporate tax payments. While the corporation's tax burden would remain unchanged, the tax receipts of the Japanese government would decline.

In other words, viewed from an international vantage point, this provision does not prevent tax avoidance, but merely boosts U.S. tax revenues at the expense of foreign corporations and foreign governments.

In addition, it unilaterally alters Japan-U.S. tax relations, which had been fixed by tax treaties affording special tax treatment to interest payments.

Such a move not only violates the spirit and intent of the tax treaties, it may also violate rules both on non-discriminatory tax treatment of domestic and foreign-owned corporations, and on non-discriminatory treatment of domestic and foreign payees in financial transactions.

The prevention of tax avoidance is a major concern in the area of international tax relations. But policies in this regard should take into account the international dimension, including the tax systems of other countries, rather than unilaterally attempting to promote the interests of a single country.

Without such an approach, the international tax system may degenerate into a beggar-thy-neighbor scramble for larger shares of corporate tax revenues.

The provision on reporting requirements, for its part, was intended to facilitate taxation in cases of transfer pricing.

Specifically, the stiffer reporting requirements would give the Internal Revenue Service information needed to calculate tax liabilities which are based not on prices used in actual transactions, but on prices judged appropriate by the tax authorities. This would help prevent tax avoidance through transfer pricing.

This provision, however, saddles foreign-owned corporations with heavier record-keeping and paperwork requirements than their U.S.-owned counterparts, clearly violating the principle of non-discrimination against foreign firms.

A Japanese parent company selling its products in the U.S. through a local subsidiary, for example, would either have to keep all of its sales and production data on file in the U.S., or be able to submit it promptly to the tax authorities upon request.

A report on transfer pricing released by the U.S. Treasury Department and the Internal Revenue Service in October 1988 suggested that, in order to tighten the tax system in relation to transfer pricing, the Basic Arm's-Length Return Method, which utilizes a standard income rate based on the average profit ratio within an industry, should be applied to foreign-owned subsidiaries for taxation purposes.

There were several factors which prompted the U.S. to adopt tougher tax provisions vis-a-vis foreign corporations.

One was the perception that foreign-owned corporations have not been paying a fair share of corporate taxes.

Top Internal Revenue Service officials have often cited figures to fuel this perception. It was noted, for example, that while foreign-owned corporations earned $500 billion in the U.S. in 1986, their reported taxable income amounted to a deficit of $2 billion.

It was also reported that, while U.S. corporations pay taxes amounting to roughly 1.5% of sales, foreign-owned corporations pay less than 1%.

While the basis of these figures needs to be analyzed further, they clearly created an image of unfairness and helped spur the Congress to adopt stricter tax measures regarding foreign-owned corporations.

This determination to promote fairness in the tax system, moreover, led the House of Representatives to take unilateral legislative action even if it was in conflict with international treaties.

The impact of these two provisions, however, will inevitably spill over into international relations.

First, there are worries that they may have a negative impact on direct investment in the U.S.

Moreover, they may undermine the role of international tax treaties. These treaties serve to prevent double taxation of corporations operating on an international scale. They also help assure a fair allocation of taxation authority, as well as clarity and stability in international tax relations. In this way they make an important contribution to the development of international economic relations as a whole.

The adoption of tax provisions which are potentially in conflict with the stipulations of tax treaties may ultimately undermine trust in the international economic order itself.

If the U.S. disregards the interests of other countries as it attempts to shore up its own taxation authority, there will be sweeping consequences, particularly in the developing countries. It may even provoke an international tax free-for-all as countries struggle for a bigger share of the tax pie.

If this is to be prevented, the U.S. Congress must take a more moderate stance. And the U.S. Treasury Department and Internal Revenue Service should take a flexible approach, which thoroughly considers international ramifications, as they implement regulations related to these two provisions.

Yuji Gomi is chairman of Chuo Coopers & Lybrant Consulting Co. in Tokyo.

Mr. Flippo. Mr. Egger.

STATEMENT OF ROSCOE L. EGGER, JR., PRICE WATERHOUSE, FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. Egger. With your permission, I would like to submit my written statement here and then just make a few comments.

Mr. Flippo. So ordered.

Mr. Egger. We can talk about my formal statement in the question and answer period.

First off, let me observe that the dramatic increase in international trade, commerce and investment both here and abroad in the last decade is so dramatic that it isn't any wonder that the issue of transfer pricing has reached the proportions that it has.

In my judgment, without any doubt today it is the single most important issue in the whole arena of international taxation. On a taxpayer-by-taxpayer basis, it is very difficult to identify which taxpayers may have the problem and which ones do not without a fairly extensive examination or investigation.

Therefore, trying to solve this problem on an audit-by-audit basis simply will not work, and the reason it won't work is, No. 1, in this day and age, the chances that the IRS is going to get enough real resources and money to pay for the kind of talent that it takes for that are somewhere between none and zero.

Second, each of these cases is so unique that you are literally reinventing the wheel. When you start on a new company, you have to begin all over again. You can't essentially emulate what you did in the last audit and expect that that is going to apply in this one.

The Service has proposed an advanced determination ruling procedure which Commissioner Gibbs referred to, and I believe that has a lot to recommend it, but by the same token it is a very costly process, costly for IRS as well as for the taxpayers. I seriously doubt that it is going to be used extensively by the foreign-based companies primarily from the standpoint of their concerns for confidentiality.

I would guess that that might also be true of U.S. companies, the confidentiality problem. The reason for that is that clearly we can't do this in a vacuum. We have to conduct this kind of procedure in conjunction with our treaty partners around the world.

And when you start to share the massive amounts of data on either a company-by-company or industry-by-industry basis with so many thousands of individuals around the world, I suspect that there is a lot of reason for people to be concerned about the confidentiality.

So while I think this whole approach has some merit, I don't think it even comes close to being a total solution to the problem. We need to do something more and we need to do something different.

We have other countries that are looking at the transfer pricing problem. We have the Western European countries as well as Japan. I can tell you that when I first took office in the IRS in 1981, the Japanese didn't even have any such provisions in their law as section 482. So we have come a long way since then.

The process is very involved. Eventually no matter whether it is the United States making a proposal for a change or whether it is a country in Western Europe or the Japanese or whomever, making the proposed adjustment in a taxpayer's return, sooner or later it is going to get into the competent authority process, and that is a very, very difficult process particularly when you have not just another country involved but in some of these large multinational operations you may have 15, 16, 18 different countries involved. Trying to find a common solution is very, very difficult.

A real effort needs to be made to develop some kind of parameter, some kind of safe harbor rule, some kind of formulas which can be used in at least a large part of international trade for taxpayers to have some kind of assurance that they are on the right track. But also to give the Internal Revenue Service the kind of solace it needs that they aren't missing something someplace when they make their examinations.

What I have in mind is that there be some kind of a cooperative study using rates of return, using net profit ratios or different statistical results of that kind, and the development then of these parameters or these formulas from which taxpayers and the Government can agree that if you fall within those parameters, those safe harbors, that you are home free.

The service has done this on a smaller scale, for example, in the petroleum industry, dealing with the problem of transportation costs in the large integrated company situation. This became an audit issue over and over again, but today there is an average rate of return that is developed by a London-based group, and reviewed by the IRS experts, and so long as companies fall within those parameters, it is acceptable to the service, with verification, of course. So it can be done.

We had the Federal Trade Commission developing line-of-business statistics back in the 1970's, and so, as I said, this can be done. But it should be done on a cooperative basis, whether we take Larry Gibbs' approach such as a roundtable approach or other suggestions such as a blue ribbon commission and so on.

I am not sure how to do that, but I am sure that with the cooperation of industry, trade associations and the Government, such a process can be worked out and form at least a part of the solution to this problem.

Thank you very much.

Mr. FLIPPO. Thank you very much.

[The prepared statement follows:]

STATEMENT OF ROSCOE L. EGGER, JR
PRICE WATERHOUSE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
JULY 12, 1990

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE: I AM ROSCOE EGGER; I AM CURRENTLY A CONSULTANT TO PRICE WATERHOUSE. IT IS A PLEASURE TO BE HERE TODAY TO DISCUSS THE ADMINISTRATION OF SECTION 482 OF THE INTERNAL REVENUE CODE. SECTION 482 HAS BECOME ESPECIALLY IMPORTANT IN THE CONTEXT OF INCREASING FOREIGN INVESTMENT IN THE U.S. A RECENT IRS SURVEY OF RATES OF RETURN WOULD SEEM TO INDICATE LOW PROFIT MARGINS FOR SOME U.S. SUBSIDIARIES OF FOREIGN CORPORATIONS IN 1986. THESE LOW PROFIT MARGINS MAY BE INDICATIVE OF TRANSFER PRICING POLICIES WHICH MAY NOT ALLOCATE SUFFICIENT INCOME TO U.S. OPERATIONS. THERE IS SOME QUESTION, HOWEVER, AS TO THE VALIDITY OF THE IRS DATA. THE DATA IN THE STUDY IS NOT CURRENT AND ECONOMIC OCCURRENCES IN 1986 MAY HAVE AFFECTED THE OUTCOME OF THE STUDY. BECAUSE OF SOME UNCERTAINTIES SURROUNDING THIS STUDY, I AM NOT SURE ANY DEFINITE CONCLUSION CAN BE DRAWN REGARDING A PROBLEM WITHIN THE TRANSFER PRICING SYSTEM. LEAVING OPEN THE POSSIBILITY, EVEN THE LIKELIHOOD HOWEVER, THAT THERE IS A PROBLEM WITH THE CURRENT APPLICATION OF SECTION 482, I WOULD LIKE TO DISCUSS GENERALLY SEVERAL APPROACHES THAT HAVE BEEN PROPOSED AND OFFER SOME OF MY OWN SUGGESTIONS. I HOPE MY COMMENTS WILL BE OF SOME ASSISTANCE TO THE SUBCOMMITTEE AS IT ATTEMPTS TO DEAL WITH THIS DIFFICULT PROBLEM OF DEFINING A FAIR AND REASONABLE METHOD OF TAXING U.S. SOURCE INCOME.

IN MY OPINION, THERE HAS BEEN NO REALLY EFFECTIVE SOLUTION OFFERED TO DATE, AND THOSE THAT HAVE BEEN OFFERED POSE POTENTIAL PROBLEMS NOT ONLY OF INEFFECTIVENESS, BUT EXPENSE AND CONFIDENTIALITY AS WELL. I WILL DISCUSS BRIEFLY SOME OF THESE PROPOSALS AND THEIR PROBLEMS.

INCREASE IRS EXAMINATIONS

WITHIN THE IRS, MORE EMPHASIS ON THE EXAMINATION OF CORPORATE TAX RETURNS IS NOT THE ANSWER. THE IRS HAS, IN RECENT YEARS, MADE A SIGNIFICANT EFFORT TO ADDRESS THIS WHOLE PROBLEM THROUGH ENHANCED QUALITY AND EFFECTIVENESS OF TRANSFER PRICING EXAMINATIONS. BUT, THEY SIMPLY DO NOT HAVE THE RESOURCES TO INITIATE A LARGE-SCALE INCREASE IN EXAMINATION ACTIVITY IN EVERY AREA. WITH JUST OVER 500 INTERNATIONAL EXAMINERS AND FEWER THAN 50 ECONOMISTS, EVEN IF THESE RESOURCES WERE INCREASED DRAMATICALLY, EXAMINERS COULD NOT EFFECTIVELY OBTAIN COMPLIANCE THROUGH A ONE-BY-ONE EXAMINATION APPROACH. TRANSFER PRICING EXAMINATIONS DEAL WITH COMPLEX ISSUES; THERE IS GREAT VARIATION IN THE FACTS AND CIRCUMSTANCES FROM CASE-TO-CASE. THERE IS THUS NO ASSURANCE THAT THE IRS CAN GET AN EVEN-HANDED RESULT. FINALLY, TRANSFER PRICING CASES BY THEIR NATURE DO NOT RESULT IN PRECISE ANSWERS. PRICING UNDER SECTION 482 IS LARGELY BASED ON PARTICULAR FACTS AND CIRCUMSTANCES; THERE IS GENERALLY NO PRECISELY CORRECT ANSWER. INCREASING EXAMINATION ACTIVITY BY THE IRS WILL NOT SOLVE THE GENERAL PROBLEM. SOMETHING MORE IS NEEDED.

ADVANCED DETERMINATION RULINGS

THE IRS HAS BEEN STUDYING THE POSSIBILITY OF ISSUING ADVANCED DETERMINATION RULINGS OR ADR'S. ALTHOUGH AN ADR WILL ALLEVIATE A SPECIFIC TAXPAYER'S UNCERTAINTY REGARDING THE APPLICATION OF SECTION 482, I DO NOT SEE ADR'S AS THE SOLUTION TO BRINGING ABOUT AN ACCEPTABLE LEVEL OF COMPLIANCE. CORPORATIONS THAT MAY BE CURRENTLY AVOIDING FULL TAXATION THROUGH TRANSFER PRICING PRACTICES WOULD NOT NECESSARILY BE REINED IN WITH AN ADR SYSTEM. ONLY THE "GOOD GUYS" (CURRENTLY COMPLIANT TAXPAYERS) WOULD REQUEST ADVANCED DETERMINATION RULINGS, IN AN EFFORT TO REDUCE UNCERTAINTY ABOUT THEIR EXAMINATION EXPOSURE. ADR'S WOULD ALSO BE COSTLY FROM THE CORPORATION'S STANDPOINT BECAUSE OF THE ENORMOUS DATA REQUIREMENTS. SMALLER CORPORATIONS COULD BE INHIBITED BY THE HIGH COST OF THE

ADR APPROACH. FINALLY, AN ADR APPROACH COULD POSE A POTENTIAL CONFIDENTIALITY PROBLEM. MARKETING SENSITIVE DATA WOULD HAVE TO BE DISCLOSED TO THE IRS, AND CLEARLY, THE ADR APPROACH WOULD NOT WORK IF DONE UNILATERALLY BY THE U.S. AS TREATY PARTNER COUNTRIES WOULD HAVE TO BE INVOLVED. THUS, THE DATA WOULD HAVE TO BE SHARED WITH OTHER COUNTRIES WHERE THE CORPORATION MAY HAVE COMPETITORS. TAXPAYERS ARE CONCERNED THAT THIS INFORMATION MAY BE OBTAINED BY THEIR FOREIGN COMPETITORS. I AM PERSUADED THAT WITH DATA IN A LARGE NUMBER OF HANDS IN MANY JURISDICTIONS, IT MAY BE NEARLY IMPOSSIBLE TO CONTROL ITS USE. THEREFORE, I BELIEVE THAT THERE IS JUSTIFICATION FOR THIS CONCERN ON THE PART OF TAXPAYERS. IT IS CONCEIVABLE THAT THIS PROCEDURE COULD PUT A STRAIN ON IRS RESOURCES AS WELL.

CURRENT LAW

MY OWN VIEW IS THAT NEITHER OF THE ABOVE APPROACHES PROVIDES MORE THAN A PARTIAL ANSWER TO THE PROBLEM. SECTION 482 WAS ADDRESSED IN THE 1986 TAX REFORM AND IN A 1988 TREASURY WHITE PAPER. IN ADDITION, I UNDERSTAND THAT THE TREASURY PLANS TO ISSUE PROPOSED SECTION 482 REGULATIONS LATER THIS YEAR. ALTHOUGH WE DO NOT KNOW WHAT NEW DIRECTIONS THESE NEW REGULATIONS MAY TAKE, IT IS HIGHLY UNLIKELY THAT THEY WILL OFFER ANY DRAMATIC CHANGE. WE CAN AND SHOULD REEVALUATE THE SITUATION AFTER TREASURY AND IRS HAVE ISSUED THESE NEW PROPOSED REGULATIONS. TAXPAYERS, PRACTITIONERS, AND OTHERS WILL HAVE THE OPPORTUNITY FOR REVIEW AND COMMENTS. BUT I DO NOT BELIEVE THE PROBLEM WILL GO AWAY.

BASIC ARM'S LENGTH RETURN METHOD

ASSUMING THE NEW REGULATIONS DO NOT PROVIDE ANY EFFECTIVE NEW DIRECTION IN THE TRANSFER PRICING AREA, PARTIAL SAFE HARBORS COULD BE CONSIDERED USING THE BASIC ARM'S LENGTH RETURN METHOD, COMMONLY REFERRED TO AS BALRM. THIS METHODOLOGY IS DISCUSSED IN THE WHITE PAPER. IT IS CERTAINLY WORTH CONSIDERING WHETHER IT WOULD BE POSSIBLE TO CREATE SOME RANGES SAY OF GROSS PROFITS FOR INDUSTRY GROUPS OR SUBSETS OF INDUSTRY GROUPS WITH DATA WHICH MAY BE PUBLICLY AVAILABLE, OR DATA WHICH WOULD BE PROVIDED BY INDUSTRY OR TRADE ASSOCIATIONS. UNDER THIS CONCEPT, IF THE TAXPAYERS' OPERATING RESULTS WERE TO FALL WITHIN THE PREDETERMINED RANGE, THERE COULD BE A PRESUMPTION THAT THE TRANSFER PRICE IS DEEMED TO BE SUFFICIENTLY ARM'S LENGTH, AND ACCEPTABLE FOR TAX PURPOSES. THIS BALRM METHOD MAY, FOR INSTANCE, BE APPLICABLE TO SIGNIFICANT NUMBERS OF U.S. DISTRIBUTION SUBSIDIARIES OF FOREIGN PARENT COMPANIES, PARTICULARLY MANUFACTURERS OF LARGE TICKET CONSUMER ITEMS. I RECOGNIZE THAT THE BALRM APPROACH IS NOT THE ANSWER FOR ALL TAXPAYERS, PARTICULARLY THOSE WITH SIGNIFICANT RISKS AND/OR INTANGIBLES.

UNDER THIS METHODOLOGY, IF CONDITIONS WARRANT, EVEN IF A TAXPAYER'S OPERATIONAL RESULTS FALL WITHIN THE SPECIFIED RANGE, THE TRANSFER PRICE COULD BE CHALLENGED BY THE IRS, BUT IN ORDER TO DO SO, THE SERVICE WOULD HAVE TO OVERCOME THE PRESUMPTION. IN ANY EVENT, SUCH CIRCUMSTANCES WOULD ADD TO THE COMPLEXITY OF ADMINISTERING THE COMPETENT AUTHORITY PROCESS IN THE WORLD OF INTERNATIONAL COMMERCE.

I BELIEVE A LARGE PART OF THIS VERY DIFFICULT AREA CAN BE ALLEVIATED WITH THE COOPERATIVE EFFORTS OF INDUSTRY, GOVERNMENT, AND THE ACADEMIC WORLD.

COMPETENT AUTHORITY

ANOTHER ISSUE I'D LIKE TO ADDRESS TODAY IS COORDINATION WITH FOREIGN GOVERNMENTS IN RESOLVING DOUBLE TAXATION ISSUES. AS YOU ARE AWARE, THE U.S. HAS AN EXTENSIVE TAX TREATY NETWORK. TRANSFER PRICING ISSUES ARE FREQUENTLY THE SUBJECT OF NEGOTIATIONS BETWEEN THE U.S. AND A NUMBER OF ITS TREATY PARTNERS AND QUITE FRANKLY THE RESULTS ARE MANY TIMES NOT SATISFACTORY. SOME WAY MUST BE FOUND TO MAKE THE COMPETENT AUTHORITY PROCESS WORK BETTER. IT HAS BEEN MY EXPERIENCE THAT DOUBLE TAXATION ISSUES ARE RESOLVED WITH SOME COUNTRIES AND NOT WITH OTHERS. TAXPAYERS OFTEN RECEIVE LESS THAN FULL RELIEF, ESPECIALLY WHEN THE IRS ADJUSTMENT IMPACTS ON A LARGE GROUP OF RELATED ENTITIES LOCATED IN A NUMBER OF TREATY COUNTRIES.

CERTAIN COUNTRIES PROVIDE FULL RELIEF THROUGH NEGOTIATIONS WITH THE U.S. COMPETENT AUTHORITY, WHILE OTHERS PROVIDE RELIEF IN PART OR DO NOT GRANT ANY CORRESPONDING OR CORRELATIVE ADJUSTMENT TO ALLEVIATE DOUBLE TAXATION. IT IS ESSENTIAL THAT THE U.S. FIND A WAY TO DEAL WITH TREATY PARTNERS WHO DISREGARD THEIR RESPONSIBILITY TO ATTEMPT TO REACH AGREEMENT ON THESE ISSUES. FOR YEARS, THE SOLUTION, WHERE THE TREATY PARTNERS DID NOT AGREE TO A FULL CORRELATIVE ADJUSTMENT, WAS TO GIVE THE TAXPAYER AN ADDITIONAL FOREIGN TAX CREDIT. BUT, SINCE THE 1986 ACT, MOST TAXPAYERS CAN'T USE THE CREDIT ANYWAY, SO THE END RESULT IS DOUBLE TAXATION. SURELY THROUGH NEGOTIATION, INCLUDING, IF NECESSARY, RE-NEGOTIATION OF THE TREATY, WE CAN GET THESE PROBLEMS WORKED OUT.

EVEN IN INSTANCES WHERE THE TAXPAYER RECEIVES A CORRELATIVE DEDUCTION WHICH RESULTS IN A REFUND OF FOREIGN TAX, INEQUITIES MAY OCCUR. SPECIFICALLY, I AM REFERRING TO THE INCONSISTENCIES WHICH MAY EXIST BETWEEN THE U.S. AND ITS TREATY PARTNERS WITH RESPECT TO THE PAYMENT OF INTEREST ON TAX REFUNDS. IN SOME INSTANCES, THE FOREIGN COUNTRY DOES NOT PAY INTEREST ON THE TAX REFUND; THE U.S. WILL, HOWEVER, CHARGE THE TAXPAYER INTEREST ON THE ADDITIONAL TAX DUE. IN VIEW OF THE TAX YEARS FREQUENTLY INVOLVED IN THESE ISSUES AND THE EXTENDED TIME IT TAKES FOR THE COMPETENT AUTHORITIES TO PROCESS THESE CASES FROM START TO FINISH, THE INTEREST COST TO THE TAXPAYER FREQUENTLY RESULTS IN A SIGNIFICANT ECONOMIC BURDEN. THE INTEREST PROBLEM IS BUT ONE OF RELATED ISSUES WHICH MAY RESULT FROM A TRANSFER PRICING DISPUTE WITH THE IRS IN THE INTERNATIONAL ARENA.

IT IS NOT EASY TO FIND SOLUTIONS TO THESE PROBLEMS, BUT I WOULD SUGGEST THAT THE PARTIAL SAFE HARBOR APPROACH APPLIED ON AN INDUSTRY BASIS, WHICH I DISCUSSED EARLIER, MAY BE OF USE IN DECREASING THE INTERNATIONAL TRANSFER PRICING DISPUTES WHICH ARE FREQUENTLY THE SUBJECT OF COMPETENT AUTHORITY NEGOTIATIONS. BUT, IN ORDER FOR THE SYSTEM TO BE EFFECTIVE, IT WOULD BE ESSENTIAL FOR THE U.S. COMPETENT AUTHORITY TO OBTAIN THE CONCURRENCE OF HIS COUNTERPARTS TO THE PARTIAL SAFE HARBORS, AS WELL, OF COURSE, TO THE METHODOLOGY FOR THE DEVELOPMENT OF THE FORMULA.

MR. CHAIRMAN, THIS CONCLUDES MY REMARKS. I WILL BE HAPPY TO TRY TO ANSWER ANY QUESTIONS YOU OR MEMBERS OF THE SUBCOMMITTEE MAY HAVE.

Mr. FLIPPO. Mr. Granfield.

STATEMENT OF MICHAEL E. GRANFIELD, FACULTY MEMBER, BUSINESS ECONOMICS, ANDERSON GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF CALIFORNIA, LOS ANGELES, CALIF.

Mr. GRANFIELD. I will make a couple of brief preliminary comments.

I think that these hearings reflect the fact that I believe that this issue will replace the trade issue as one of the most contentious international economic policy issues of the 1990s and further on, for obvious reasons.

You have increasing international economic activity controlled by multinational corporations and the fundamental issue is, how do we tax that income generated by these corporations that is fair to all the sovereign countries involved. That is why I advocate that we have to take a fresh look at 482, and the United States should take the lead in that because we have been the leader in this area.

A lot of our major trading partners are just coming now to some of the problems surrounding effective enforcement of 482.

As background, I served as lead economist for the IRS in the initial Japanese automobile cases that were ultimately settled in favor of the IRS for a reported $650 million. I have also worked for various foreign and U.S. parents and subsidiary corporations in the automobile, motorcycle and electronics distribution industries.

Accordingly, I have seen the issues of section 482 compliance and enforcement from the dual perspective of the IRS and the taxpayer.

Based on these experiences, my reading of the major 482 cases, and my professional contacts with other 482 practitioners, I will briefly respond to the major questions raised by this Oversight Subcommittee.

I support the committee's conclusion that there indeed appears to be a serious compliance problem if they compliance is meant an adherence to the spirit and intent of section 482.

However, I believe it is a serious mistake and a distortion to treat this subject in too broad a context.

It is erroneous and misleading to state that all firms in a particular industry or from a particular country are guilty of underpaying their taxes relative to section 482.

Not only is this a disservice to many of the firms involved who are acting in compliance with section 482, it also leads one to adopt broad, punitive prescriptions that will not work and will not change the current situation.

Probably the most important lesson I can offer to this committee is to emphasize that no two industries are alike and that firms within an industry can differ substantially from each other.

The implication for appropriate 482 enforcement, therefore, is that one must understand the basic economies of what ultimately generates profits in a particular industry. This is not a simple task but once having mastered the basic tenets of this analytical exercise, one can then examine in detail the particular facts and circumstances of the individual taxpayer in the proper context.

In this vein, a major criticism I have of the IRS is that the industry studies that I have seen that they have done in the electronics and motorcycle industries are seriously deficient. They have led the service to propose comparisons and make 482 adjustments that are completely unfounded and unreasonable and ultimately cannot prevail.

If we are to have better 482 compliance, we clearly need better fundamental economic analysis on the part of the IRS. In defense of the IRS, one of the problems they encounter is a lack of sufficient resources, particularly human capital. Thus, if this committee is serious, it must address this key problem both in terms of an overall budget for the IRS and simultaneously in the compensation structure for IRS professionals.

I have dealt with very competent IRS people over the years, but generally speaking they are simply stretched too thin. But in the area of economic analysis, I think they have been particular deficient. But in the accounting and legal area, I have met some very good people.

You have heard enough about how companies go about changing their 482 liability, so I won't go into that.

Section 482 as an adequate enforcement tool: As the IRS revealed in its white paper and, as is apparent from the very existence of these hearings, section 482 is simply an inadequate policy tool both from the perspective of enforcement but also from the perspective of tax compliance by responsible taxpayers.

Ironically, the current regulations probably work best for analyzing distributors, but overall there are serious deficiencies, I think particularly of high-technology firms both in the United States and overseas.

To rectify the current situation, two separate approaches need to be considered. The first approach would be to fix the current 482 regulations by: First, adding more alternatives to the current alternatives available under 482 including at least a safe harbor structure; second, eliminating, except in the case of an obvious CUP, the priority ordering of the regulations; and third, abandoning the notion that one single approach—for example, return on assets—can work for most taxpayers in most situations.

Mr. FLIPPO. Pardon me for interrupting you. We have only 5 minutes left to go to the chamber and vote. Our distinguished chairman is rushing back to hear the rest of the testimony, and we will return as soon as we vote, but I would like to recess at this time for 5 minutes and see if we can catch this vote.

Thank you. We will be right back.

[Recess.]

Chairman PICKLE. The Chair would ask the subcommittee to please come to order.

Professor Granfield, I understand you were in the midst of your statement. Can you tell me where you were?

Mr. GRANFIELD. I am on the bottom of page 2, sir.

Chairman PICKLE. Go ahead.

Mr. GRANFIELD. I just briefly reviewed, Mr. Chairman, the first three bullets there, indicating some of the things I think we could do now to improve enforcement.

The second approach, the one I favor, is to convene a working commission made up of senior IRS, Treasury, and Ways and Means members to be supplemented by practitioners and academics that would attempt to come up with an entirely new approach to section 482.

From an international perspective, this will ultimately have to be done in any event so the United States might as well take the lead and get on with it.

In other words, the current United States approach to international transactions and the appropriate transactions and the appropriate allocation of income is simply not working very well from anyone's perspective. No other government, who also takes 482 issues seriously, has found an acceptable solution either so it is a fortuitous time to consider major new approaches.

It is apparent that the IRS is not doing an adequate job in this area. As stated previously, many of these difficulties may not be of their making. They clearly have inadequate resources and as with many senior Federal civil servants, compensation levels make it impossible to keep the best and the brightest. Retention is particularly crucial in 482 matters because broad experience is critical to effective performance.

In addition to problems not of its own making, the IRS has generated many of its own difficulties which ultimately show up as insufficient taxes paid mostly because cases do not get resolved in a timely manner.

The major problems as I see them are: First, the quality of analysis is very low leading to adjustment that are not documented and thus subject to major shortcomings; second, on top of inadequate analysis, the IRS often requests such high levels of adjustment that they are counterproductive. Namely, they are so high that it compels the taxpayer to resist prolonging any settlement; third, because of poor analysis and excessive adjustment requests, the IRS compels some taxpayers to go to court where in the recent *Bausch & Lomb* case, the IRS is found to be arbitrary and capricious. Not only is such a performance wholly unjustified, it generates an environment bound to lead to more delays and litigation; fourth, the IRS does not seem to learn from its mistakes. It repeats the same analytical and strategic errors in case after case. They often appear to have a lottery mentality. Namely, go for the largest conceivable settlement even though only 1 in a thousand taxpayers will ever concede at that level; fifth, the IRS must recognize that a case that is over 5 or 6 years old is becoming a failed case even if the requested adjustment on the books is significant. Any settlement that is still pending after 10 years should be graded with an F and disposed of expeditiously; and sixth, rather than always seeking large settlements based on inadequate analysis, the IRS should seek, early on in the tax cycle, to establish certain income allocation principles. This is particularly useful with distributors.

We have had some discussion of that at these hearings. I am not sure I would be so aggressive as to go to an 8- to 10-percent return on sales but I think it is critical to devise some percentage that would set a floor over a period of years, say 7 to 10 years or 5 to 8 years. Clearly, if these companies are here operating over a long period of time, they indeed are profitable.

With respect to the latter, the IRS might argue that it is too generous to the taxpayer and will create a de facto safe harbor.

My response is twofold: One, in today's environment, they are often not effectively collecting at all—the cases are still pending—which translates into an effective tax rate of zero; and two, careful analysis and monitoring can prevent the de facto creation of a safe harbor.

New initiatives: First, the whole 482 area needs to be reviewed by an appropriate blue ribbon commission with the goal of coming up with a new international approach to 482; second, in the interim, current 482 regulations need to be buttressed with more options and a formal safe harbor. The strict priority of the 482 provisions also needs to be abandoned; third, the IRS needs more resources and the ability to compensate its senior administrators and field personnel more effectively to attract and retain the necessary personnel. There are extremely able IRS people today but they are both overburdened and undercompensated; and fourth, the IRS must commit itself to do much higher quality industry-by-industry and firm-by-firm analysis. It must avoid both broad-brush approaches that lead to naive and indefensible adjustments. The adjustments sought must be realistic and not arbitrary.

The goal should be to establish basic allocation principles that ensure reasonable long-term revenue growth and avoids the paralysis that currently characterizes much of its actions in these key industries.

[The prepared statement follows:]

STATEMENT PREPARED FOR THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
BY
DR. MICHAEL E. GRANFIELD

TOPIC: TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES -- "TAX GAP REVIEW" PROCESS

WITNESS: DR. MICHAEL E. GRANFIELD, VICE CHANCELLOR, ACADEMIC PLANNING AND BUDGETING, UCLA

CAPACITY: WITNESS, DR. MICHAEL E. GRANFIELD, APPEARING IN THE CAPACITY OF FACULTY MEMBER, BUSINESS ECONOMICS, ANDERSON GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF CALIFORNIA, LOS ANGELES

DATE: JUNE 27, 1990

INTRODUCTION

As background, I served as lead economist for the IRS in the initial Japanese automobile cases that were ultimately settled in favor of the IRS for a reported $650 million (see TAX NOTES, Vol. 46, No. 10). I have also worked for various foreign and U.S. parents and subsidiary corporations in the automobile, motorcycle and electronics distribution industries.

Accordingly, I have seen the issues of Section 482 compliance and enforcement from the dual perspective of the IRS and the taxpayer.

Based on these experiences, my reading of the major 482 cases, and my professional contacts with other 482 practitioners, I will briefly respond to the major questions raised by this Oversight Committee.

COMPLIANCE BY FOREIGN OWNED SUBSIDIARIES

I support the Committee's conclusion that there indeed appears to be a serious compliance problem if by compliance is meant an adherence to the spirit and intent of Section 482.

However, I believe it is a serious mistake and a distortion to treat this subject in too broad a context.

It is erroneous and misleading to state that all firms in a particular industry or from a particular country are guilty of underpaying their taxes relative to Section 482.

Not only is this a disservice to many of the firms involved who are acting in compliance with Section 482, it also leads one to adopt broad, punitive prescriptions that will not work and will not change the current situation.

Probably, the most important lesson I can offer to this Committee is to emphasize that no two industries are alike and that firms within an industry can differ substantially from each other.

The implication for appropriate 482 enforcement, therefore, is that one must understand the basic economics of what ultimately generates profits in a particular industry. This is not a simple task but once having mastered the basic tenets of this analytical exercise, one can then examine in detail the particular facts and circumstances of the individual taxpayer in the proper context.

In this vein, a major criticism I have of the IRS is that the industry studies that they have done in the electronics and motorcycle industries are seriously deficient. They have led the service to propose comparisons and make 482 adjustments that are completely unfounded and unreasonable.

If we are to have better 482 compliance we clearly need better fundamental economic analysis on the part of the IRS. In defense of the IRS, one of the problems they encounter is a lack of sufficient resources particularly human capital. Thus, if this Committee is serious, it must address this key problem both in terms of an overall budget for the IRS and simultaneously in the compensation structure for IRS professionals.

REDUCING 482 LIABILITIES THROUGH TRANSFER PRICING

The mechanisms for altering a foreign subsidiary firm's tax liability are rather straightforward:

1) The transfer price for the major products in question are raised by the parent over time; or the price is not reduced as much as it should be to reflect cost economies experienced by the parent. In both instances, the Parent's share of the combined income is too high.

2) The burden of related costs such as interest expense on inventories, exchange rate risks, and warranty expenses are borne by the distributor with no corresponding price concession to the subsidiary.

The compliance problem that one faces is to determine when these factors have been manipulated to such an extent that significant underpayment of taxes occurs. This can be difficult to prove or demonstrate and, absent flagrant abuse situations, requires careful analysis to detect and rectify.

SECTION 482 AS AN ADEQUATE ENFORCEMENT TOOL

As the IRS revealed in its White Paper and, as is apparent from the very existence of these hearings, Section 482 is simply an inadequate policy tool both from the perspective of enforcement but also from the perspective of tax compliance by responsible taxpayers.

To rectify the current situation, two separate approaches need to be considered. The first approach would be to fix the current 482 regulations by:

1) Adding more alternatives to the current alternatives available under 482 including at least a "safe harbor" structure;

2) Eliminating, except in the case of an obvious CUP, the priority ordering of the regulations;

3) Abandoning the notion that one single approach (e.g. return on assets) can work for most taxpayers in most situations.

The second approach, the one I favor, is to convene a working commission made up of senior IRS, Treasury, and Ways and Means members to be supplemented by practitioners and academics that would attempt to come up with an entirely new approach to Section 482. From an international perspective, this will ultimately have to be done in any event so the U.S. might as well take the lead and get on with it.

In other words, the current U.S. approach to international transactions and the appropriate transactions and the appropriate allocation of income from is simply not working very well from anyone's perspective. No other government, who also takes 482 issues seriously, has found an acceptable solution either so it is a fortuitous time to consider major new approaches.

IRS PERFORMANCE IN THE 482 AREA

It is transparent that the IRS is not doing an adequate job in this area. As stated previously, many of these difficulties may not be of their making. They clearly have inadequate resources and as with many senior federal civil servants, compensation levels make it impossible to keep the "best and the brightest." Retention is particularly crucial in 482 matters because broad experience is critical to effective performance.

In addition to problems not of its own making, the IRS has generated many of its own difficulties which ultimately show up as insufficient taxes paid mostly because cases do not get resolved in a timely manner.

The major problems as I see them are:

1) The quality of analysis is very low leading to adjustments that are not documented and thus subject to major shortcomings;

2) On top of inadequate analysis, the IRS often requests such high levels of adjustment that they are counter-productive. Namely, they are so high that it compels the taxpayer to resist, prolonging any settlement;

3) Because of poor analysis and excessive adjustment requests, the IRS compels some taxpayers to go to court where in the recent Bausch and Laumb case, the IRS is found to be "arbitrary and capricious." Not only is such a performance wholly unjustified, it generates an environment bound to lead to more delays and litigation;

4) The IRS does not seem to learn from its mistakes. It repeats the same analytical and strategic errors in case after case. They often appear to have a "lottery" mentality. Namely, go for the largest conceivable settlement even though only one in a thousand taxpayers will ever concede;

5) The IRS must recognize that a case that is over five or six years old is becoming a "failed" case even if the requested adjustment "on the books" is significant. Any settlement that is still pending after ten years should be graded with an "F" and disposed of expeditiously;

6) Rather than always seeking large settlements based on inadequate analysis, the IRS should seek, early on in the tax cycle, to establish certain income allocation principles. This is particularly useful with distributors.

For distributors, for example, over a five to seven year period, assuming no major industry specific calamity, the firm should earn at least "X%" on sales, i.e. a minimum but certainly not a maximum tax. Further, the income split over the period between the parent and the subsidiary must give at least one third to the subsidiary.

With respect to the latter, the IRS might argue that it is too generous to the taxpayer and will create a de facto safe harbor.

My response is twofold: 1) in today's environment, they are often not effectively collecting at all (the cases are still pending) which translates into an effective tax rate of zero; and (2) careful analysis and monitoring can prevent the de facto creation of a safe harbor.

NEW INITIATIVES

1) The whole 482 area needs to be reviewed by an appropriate "Blue Ribbon" commission with the goal of coming up with a new international approach to 482.

2) In the interim, current 482 regulations need to be buttressed with more options and a formal safe harbor. The strict priority of the 482 provisions also needs to be abandoned.

3) The IRS needs more resources and the ability to compensate its senior administrators and field personnel more effectively to attract and retain the necessary personnel. There are extremely able IRS people today but they are both overburdened and undercompensated.

4) The IRS must commit itself to do much higher quality industry-by-industry and firm-by-firm analysis. It must avoid both "broad brush" approaches that lead to naive and indefensible adjustments. The adjustments sought must be realistic and not arbitrary. The goal should be to establish basic allocation principles that insure reasonable long-term revenue growth and avoids the "paralysis" that currently characterizes much of its actions in these key industries.

Chairman PICKLE. I certainly thank you. These are good recommendations.

I have questions, but let me go to Dr. Wheeler. We are delighted to have you. You are recognized as an expert in this general field, so we are honored to have you with us. Your entire statement will be made a part of the record.

STATEMENT OF JAMES E. WHEELER, PROFESSOR OF ACCOUNTING, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

Mr. WHEELER. Thank you very much.

I want to take this opportunity to thank the committee. It is a privilege to be able to serve one's country in this regard, and particularly to try to help improve our tax system.

In my testimony I would like to be able to make a few corrections before it goes to the Congressional Record.

Chairman PICKLE. That privilege will be extended to you.

Mr. WHEELER. Maybe for the people in the audience, on page 12, the last column of those tables should be struck. There are several errors there and it is easier just to strike the last column.

Chairman PICKLE. Receipts returned?

Mr. WHEELER. That is right.

Chairman PICKLE. In all three columns?

Mr. WHEELER. That is correct. Perhaps I should give you a little bit of my background before going into the statement.

I have been an expert witness for the Government in several large 482 cases and I am currently under contract on several others. I have spent a year with the staff of the Joint Tax Committee years ago when Larry Woodworth was chief of staff.

I also spent a year fairly recently with chief counsel, international group—both of these times while I was on leave from the University of Michigan. I have written several articles in the area, and I guess that is enough of my background.

I am also actively involved in the professional side as well as being an academic. I am currently on the executive committee of the American Institute of CPA's Federal Tax Division and chairman of the Corporate Tax Policy Committee of the American Tax Association, but I am here representing myself as an individual.

I would like to look briefly at tables 1, 2 and 3, and specifically at table 1 and sort of in the middle you see a computation return on assets. If you were to average these 5 years, the return on assets would be point 38, if I have done my math correctly. This means that the assets of U.S. subsidiaries, of foreign parents, are earning less than one-half of 1 percent when you take a look at the tax return. Before you invest money, you expect a returns.

You will not continually invest at one-half of 1 percent or less, not when the opportunity is there to invest in Treasuries at nearly 8 percent. These companies, because they face risks far greater than investing in Treasuries, are earning far greater on a pretax basis, greater than 8 percent, and certainly greater than point 38. This would also be a pretax rate of return.

Chairman PICKLE. Greater than 8 percent?

Mr. **Wheeler**. That is right. Over time, they are earning more than an 8 percent rate of return because they could earn nearly that right now investing in Treasuries and have no risk at all.

It is interesting to take a look at table 3 and see a huge jump in the distributions by the subsidiaries back to the foreign parent. Over a $2 billion increase in distributions by corporations suffering losses.

Earnings are the wellspring, if you will, from which dividends flow and if the well goes dry, you simply won't be pumping dividends out, but they do. They may be actually returning to the parents tax-free dividends, in other words, if their earnings and profits account is negative, then they can distribute that money back to the parents and even escape with the holding tax on dividend distributions.

If you take a look at graph No. 1 on page 13, just concentrate on the dots, just work back from the right to the 5 last years, you will see in the last 4, you will see 3 out of the past 4 the dividends exceeded the earnings.

There is no U.S. corporation that I am aware of that has consistently, or at least in 3 out of 4 years ever paid dividends in excess of earnings.

If you drop down to graph 2, you see a line showing what their earnings would have looked like had they earned 8 percent on their assets. The bottom line is what they actually reported, so the difference between what is reported and the 8-percent line, the tax on the difference, might be looked at as the shortfall. That shortfall exceeds $30 billion.

So when you used that figure $30 billion earlier, I think I would look at that as sort of the bottom line. I think that is just about the minimum of what the tax should have been, assuming that they earned 8 percent.

Several witnesses have said that information is the key to the solution to this problem, and I absolutely agree with that. We are not doing a good job of obtaining information.

The Securities and Exchange Commission forces U.S. corporations to disclose their sales, their operating profit and their assets by geographic location. In other words, a U.S. corporation must show its U.S. sales, its U.S. operating profit and its U.S. assets, and then show the same thing of foreign locations.

Well, if you have operating income disclosed, operating profit and assets, it is easy to calculate a rate of return. When foreign corporations come to the United States, the SEC waives that disclosure requirement.

Now, Ken Gideon in his testimony was a little concerned about reciprocal arrangements. He was afraid of other countries reciprocating by turning around what you want to do.

It is interesting because Japan, United Kingdom and other countries force U.S. subsidiaries in their countries to prepare financial statement information which is waived by the SEC here. In other words, they are forced to prepare financial statements in addition to their tax return. In some of those countries, those financial statements are then printed in the newspapers.

It seems to me that we are missing a whole lot of information that is very key to investors. I couldn't agree more with the idea of the globalization of the world economies and we haven't seen anything yet.

Wait till Russia gets on line and all of Eastern Europe, and that is all to everyone's benefit in the long run. But as that comes down the pike, we have got to have a better measurement system worldwide. We need a worldwide accounting system that is at least substantially the same country to country.

Today there are a ton of differences between financial reporting in Japan and in the United States. Just using Japan as an example, many of the Japanese subsidiaries' incomes are not required to be taken in their financial reporting to their shareholders.

Thus, the net incomes that those corporations report in Japan are nowhere near the net incomes they would report if they were using United States or Canadian or Great Britain standards. And as a consequence, and in my paper I gave an illustration, Kawasaki, where they suffered losses but yet the price of their stock stayed fairly stable in the marketplace, what happens when a U.S. company's earnings drop, it is reflected almost immediately in their stock prices as soon as the market finds out they are having a bad year. So I really believe that information is the real key.

If you were to ask me what you have asked other witnesses, are the foreign firms being overly aggressive, I think I like Mr. Shaw's illustration of it. And I like what Mike Granfield said. Some of them are not. Some of them are being very fair. Some of them are being overly aggressive. Some of them are going through tax evasion, which is the illegal and criminal side, and in effect constituting tax fraud.

If some of these returns were individual returns rather than corporate returns, we would see a far different attack by the IRS and the IRS has not been effective, and I am not sure that they can be with the situation the way it is today.

I put a little bit of information on page 6 of my report concerning Sony Corp. Sony is a corporation that got started in the United States. Sony was not a member of a Japanese Keiretsu. They had trouble getting started and they started the company in the United States much as Honda with cars. Honda is a very small car manufacturer in Japan, and there are other Japanese companies that got their start in this country.

Sony is listed on the New York Stock Exchange. As such, they are subject to an annual filing with the SEC called a 20(f). Those statements require the separate disclosure of sales operating profit and assets, and also the separate disclosure of before-tax income into its U.S. and foreign sources.

U.S. corporations give away an awful lot of information in the annual reports. The SEC, however, waives all that segment of reporting for all foreign corporations even though it is in the 20-F requirements as you read them in the filing of form 20.

Sony, much to its credit, provided some of that information that other Japanese companies have not. So for other Japanese companies, I could not have gone to their 20-F and got this data.

Sales by Sony are broken down by sales in Japan, United States, and Europe. You can see 34.1 percent of their sales are in Japan, 27.3 percent in the United States. If you go back to 1985, the United States was their biggest market. Part of this is due to the shift in the value of the dollar. That 34.1 percent of sales generated, apparently the income before taxes of 61.9 percent thus generated 71.2 percent of the current tax payments.

If you were to take the income tax current there and divide it by their before-tax income, you would see an average rate of 63 percent in Japan versus 41 percent worldwide. You cannot look at statutory tax rates and say that the United States with a 34 percent rate and Japan with a 50-percent rate that you will not shift income out of the low-taxed U.S. company to the high-taxed Japanese company. Indeed, you will, and that is happening today.

The reason it is happening is if $100 leaves the United States because of the measurement system, there is no guarantee that that $100 appears in Japan. What will appear over in Japan maybe is $40 of the $100. If you tax the $40 at 50 percent you have only paid $20 in tax vis-a-vis the $34 in United States

There is also no guarantee, even if the $100 appears in Japan in year 1, that it will not in year 2 appear in Singapore where Japan has a tax-sparing treaty. If the subsidiary in Singapore has a tax holiday granted by the Singapore government, then the tax rate difference you would be looking at is the 34 percent United States and zero in Singapore. So even though you might be successful in reallocating in 1 year, in year 2 that income may be in another country.

So there are some very significant problems involved. I would like to focus for a minute on 2 of them. One that really bothers me—well, both bother me a great deal, but one of them is the provision in the Japanese law where they can write off the investment in their sub account.

Let me give you an example. Supposing I am a Japanese parent company and I am efficient in producing motorcycles. I produce $1 million worth of motorcycles. And I want to start a business in the United States and I have never been here before. So I set up a subsidiary in the United States and I contribute the $1 million in motorcycles to that subsidiary and take back its subsidiary stock as consideration.

Now I have this investment in the sub account and it is worth $1 million. The subsidiary located in the United States has $1 million worth of motorcycles and it is going to compete against the only motorcycle corporation left here, Harley-Davidson.

Now, the U.S. subsidiary, I wanted to take away Harley-Davidson's market, so I will have the U.S. subsidiary sell that $1 million in motorcycles for $700,000. There would be an immediate loss of $300,000. Under Japanese law if that subsidiary operates at a loss I can write off the investment in Japan.

If I write off the $1 million in Japan against the Japanese taxes at a 50-percent rate, I will save $500,000 in Japanese taxes and add that to the $700,000 that I made selling the motorcycles in the United States, and I have $1.2 million. I made a $200,000 profit by selling at a loss and Harley-Davidson cannot even turn over their starters in competition. They are gone. They are down the tubes.

Chairman PICKLE. They cannot compete with them.

Mr. WHEELER. They cannot compete when it is like that. If a country establishes a law in that country which encourages the underreporting of income in another country such as the Japanese law with this investment subaccount, then I think we should not question their motivation but we should darn sure change our law to be sure they don't get a double deduction.

They took $1 million worth of inventory, deducted it twice, deducted it once on the Japanese return. It was not inventory any more. It was called investment in a subsidiary. They deducted it on the U.S. tax return also.

Chairman PICKLE. Commissioner, is that practice going on?

Mr. GIBBS. I am fascinated.

Mr. WHEELER. I will give you another even more fascinating one. I have not seen this one. I have talked with people in the field.

During my spring break instead of doing the typical student thing of going to Florida, I went to Tokyo. I spent 10 days over there talking to business people, both Japanese business people, the head of their national tax bureau, and some CPA's.

One of the things that I learned is that when a Japanese company goes out and acquires another company, if they acquire the assets of the company they get to write off immediately any goodwill involved for tax purposes, an immediate deduction. But if they acquire the stock of that company, then they are going to have a subsidiary and they don't get the goodwill writeoff.

We have read in the papers that Sony has acquired Columbia Pictures. I know they acquired stock. Why did they acquire stock when they could have acquired the assets and got an immediate writeoff in Japan for the goodwill? All you have to do is think about Columbia Pictures and you can imagine the volume of goodwill in the purchase price, something like $3 billion. It was a lot of goodwill potentially.

Under the U.S. law—and this is the reason in tax planning you have to consider the law of every country you are working in—under the U.S. law you make a section 338 election which changes a stock acquisition into an asset acquisition. So the Japanese parent says, well, I have an asset acquisition. Therefore, if it was an asset acquisition, even if for but a fleeting moment in time I must have owned those assets. If I owned the assets I must be able to write off the goodwill against my Japanese taxes.

Now, I doubt if that changes the value that is allocated to the U.S. assets, so I think that amount of goodwill will eventually be deducted twice, once on the Japanese return and again on the U.S. return.

Notice the difference in the incentives. In Japan corporations wanted goodwill to be sky high, but here corporations will fight tooth and nail to produce creative intangibles. They try to drive down the goodwill by assigning the amount of goodwill to items that will be deductible over a shorter life period. goodwill does have a basis when you buy it directly. It is treated like land. If you later sell it, you get to recover your basis just like land.

Those two items are particularly troublesome to me.

Chairman PICKLE. Do either one of our Commissioners want to comment on this aspect?

Go ahead, then.

Mr. GRANFIELD. I can say when I worked on the automobile cases, Mr. Chairman, we had to try to understand the motivation if this in fact was going on, income shifting from the United States to

Japan. I will support what Jim Wheeler said, in my investigations and in working with the Service, one cannot tell the effective tax rate in Japan by knowing statutorily what is going on. They are two different worlds. A lot of the tax policy is not written down anywhere.

I am not suggesting that is untoward. It is a very different environment than tax compliance in the United States. You can tell that by looking at their gross sales, income and taxes paid, and look at all the statutory rates, and you can never come up with a formula that connects the two. Again, I am not suggesting that is untoward. I am saying it is a lot more complicated than looking at what our system is.

Chairman **Pickle**. Thank you. Go ahead.

Mr. **Wheeler**. Because of the SEC reporting requirements for Japanese firms that list securities here, I would like to see a reporting requirement. If they do business in this country in either a subsidiary or branch mode, then they would have to have the exact same disclosure as U.S. firms, whether they list securities here or not.

U.S. companies have to make that disclosure. They are competing against the U.S. companies. Let's level the playing field. Let's have the same disclosure of all competitors. Let's not run a 100-yard race and start them on the 70-yard line. Let's start everybody in the same place with the same financial disclosure.

My report may upset you a little. One of the ways to get disclosure is to make tax returns public. That would eliminate a whole lot of cheating. No Japanese firm is going to put their tax return out there for the public and show all their workers that they all paid a lot more tax as individuals than this company that is investing billions and buying up things.

That is one way to get a little bit of compliance. Another way I think is the idea of changing the alternative minimum tax. That is in my paper. The alternative minimum tax today is so complex that it is mind-boggling. Here is a way to achieve two things, simplification and equity. Today the minimum tax is completely inadequate in touching transfer pricing problems. The rate of return on the assets would do that.

With that, I will conclude my comments. Thank you very much.

[The prepared statement follows:]

Statement of James E. Wheeler

Professor of Accounting
Graduate School of Business Administration
The University of Michigan

The Problem Area

In these hearings, we are looking only at the so-called in-bound aspect of the Section 482 problem; there is, however, a very major out-bound companion to the in-bound problem.[1] Perhaps the major differences between in-bound and out-bound transactions involve (1) the measurement and reporting of income and (2) the availability of the books and records. Transfer pricing is generally the largest single factor affecting in-bound transactions. There are, however, many other deductions below the gross profit line (such as interest, service fees, royalties, advertising and etc.) that often adversely impact a U.S. subsidiary's taxable income when compared to the parent corporation's income.

Historically, most tax cases involving section 482 have been of the out-bound variety. These are far easier to audit as the principal books and records are physically located in the U.S., the records are kept in English and the financial reporting to shareholders and other parties is based on U.S. reporting requirements. Even here, however, the results achieved by the IRS in these tax cases have not been very good. Whether this is due to poorly formed income tax laws, inadequate auditing and case preparation by the IRS, or inadequate understanding by the courts, the results have encouraged increased over aggressiveness by a large number of multinational taxpayers in the preparation of their income tax returns.

For several years, the Statistics of Income (SOI) Division of the Internal Revenue Service (IRS) has been releasing some very interesting data compiled from income tax returns of foreign owned U.S. subsidiaries. In addition, SOI employees, in their articles in the SOI Bulletin, have been pointing at the problem of low tax payments for several years (see especially articles by James R. Hobbs[2]). SOI should be complemented on its efforts to call attention to this problem. Hopefully these hearings will result in some significant improvements in the administration of our income tax laws so as to produce more equitable results. In any event, the budget for SOI should be increased and they should be encouraged to make even more information available. **Information is the key to the solution of this problem.**

Data Sources

Tax Return Data

The graphs and tables (included at the end of this presentation) were produced from SOI supplied tax return data. Since others (with access to more information including 1987 data) have carefully analyzed these data, I have made only a few computations. Table 1 shows the return on assets of all foreign based U.S. subsidiaries to be less than one percent. Yet with this extremely low return, the investment in U.S. assets is rising rapidly.

Graph 1 is a comparison of the "income less deficit" amounts compared to the dividend payments of all foreign owned U.S. subsidiaries for the years indicated. This graph shows that dividends are rising while the income, the well spring from which dividends flow, is falling and reached a negative position in 1986 for all foreign owned U.S. subsidiaries in the aggregate.

In real economic situations, when incomes fall generally so do dividends, and dividends do not exceed income. In fact, a dividend distribution of 20% of income is often considered generous. Some of the corporations reporting losses are also making significant distributions to their foreign parent corporations. In these cases, the foreign parents are not only receiving distributions from their U.S. subsidiaries without the payment of U.S. income taxes on U.S. earnings, but these distributions may be escaping the withholding tax. Distributions characterized as "liquidating" rather than as dividends (due to negative "earnings and profits" (E&P)) may escape the U.S. withholding tax on dividends because they will be deemed to be returns of capital instead of dividends. For 1986 distributions as a percentage of total receipts was actually higher (1.29%) for corporations reporting deficits than for corporations reporting incomes (.86). Distributions by corporations reporting deficits rose to $2,644 million in 1986 from $372 million in 1985.

Graph 2 compares the dividend payments with the income that would have been reported if the assets reflected on these tax returns had earned at a low 8% before tax rate. The 8% yield comparison makes the dividend payments seem more rational. With the U.S. Treasury paying in the 8% range for 1986, it should be obvious that these foreign owned U.S. assets, much more risky than U.S. Treasury bills, must be yielding more than 8%. With $840 billion in total assets in 1986, a conservative 8% before tax yield would generate $67.2 billion in taxable income and at a 46% tax bracket, in that year, income tax payments would have approached $30.9 billion.

The Need for More Public Information

There are two major sources of corporate income tax data (1) corporate tax returns and (2) annual and other financial reports to shareholders reporting income and taxes.

Tax Return Data.--There is an interesting question as to whether the tax returns of major corporations should be in the public domain. Today the tax returns of most nonprofit corporations, such as the American Petroleum Institute or universities and churches, are publicly available. Also if 1% or more of the stock of a U.S. corporation is owned the U.S. Treasury is required to furnish, upon request by that shareholder, the tax returns of the corporation (see Code section 6103(e)(1)(D)(iii)).

Corporate raiders, for example, have to notify the SEC when they obtain over 5% of a corporation's stock; but they can obtain over 1% and have access to a target's tax returns. Is it proper to make tax returns available to corporate raiders and not to make the same returns publicly available to investors? Do foreign corporations ever obtain over 1% of the U.S. corporations with whom they compete in order to obtain additional tax return data not publicly available?

If the large multinational corporate income tax returns were publicly available, there would be a great deal more academic research with much more valid results than currently exists. One of the principal problems in doing any useful tax research is the lack of adequate data.

About the only data publicly available today comes from the Statistics of Income (SOI) Division of the IRS. This division has produced much useful data for government as well as academic researchers, but they are constantly at risk for inadvertent disclosure of the identity of the corporate tax data. If major corporate tax returns were made public there would be a quantum leap in useful tax research. In addition, public disclosure might reduce the more aggressive positions being currently taken in the preparation of those returns. How many foreign owned U.S. subsidiaries would be willing to tell their local communities and employees that even though they have large sales, a growing share of a market, and are continually investing in U.S. assets, they are paying less income tax than each of the individual workers in their factories?

Financial Reporting Data.--The SEC. requires corporations listed on U.S. stock exchanges to disclose the source, U.S. or foreign, of their before tax income in their annual reports to their shareholders. This requirement is contained in the reporting rules for the 10-K annual report of listed domestic corporations and also in the 20-F annual report of listed foreign corporations. In addition, these annual reports also require the separate disclosure of sales, operating profit and identifiable assets by major product line and by major geographic area. While this segmental information is valuable to creditors, shareholders and potential investors, it is also valuable to the Internal Revenue Service (IRS) in determining the extent of tax avoidance by listed corporations.

Unfortunately, however, the SEC waives the disclosure requirement for all listed foreign corporations filing Form 20-F. Thus the IRS losses valuable information and U.S. investors are given less information on foreign corporations than on U.S. corporations. Because of this, foreign firms have access to the U.S. marketplace for funds on more favorable terms than do U.S. corporations.[3] The SEC should be severely criticized for waiving the reporting requirements for foreign firms. The following was taken from the Price Waterhouse "Report Of Independent Accountants" to the Sony Corporation:

> "The company has not presented segment information for the year ended ... March 31, 1989. In our opinion, the presentation of segment information concerning operations in different industries, and foreign operations and export sales is required by accounting principles generally accepted in the United States of America for a complete presentation of the consolidated financial statements."[4]

A U.S. corporation is not permitted to have such an exception in its annual report to the SEC. Even though Sony had the SEC waiver, they did disclose more information than almost any other Japanese corporation. The Sony 20-F filing disclosed the following for the year ended March 31, 1989 (in thousands of dollars and percentage):

	Sony Corporation	
Sales:		
Japan	$5,540,129	34.1%
U.S.	4,441,500	27.3
Europe	3,771,530	23.2
All other	2,499,333	15.4
Total sales	$16,252,492	100.0%
Income Before Taxes:		
Japan	$775,689	61.9%
Foreign	478,220	38.1
Total	$1,253,909	100.0%
Income Taxes Current:		
Japan	$491,614	71.2%
Foreign	198,757	28.8
Total	$690,371	100.0%

In analyzing the above data, Sony is saying that 34.1% of the sales (Japanese) generated 61.9% of the income before tax and 71.2% of the current income tax payments. Or in other words, the foreign sales of 65.9% generated only 38.1% of the income before tax and only 28.8% of the current tax payments. Whether any of the $198,757 was paid in the U.S. is not disclosed.

Even with this waiver of reporting rules some foreign firms seem to resist listing on the U.S. stock exchanges. The solution to this problem is to require all major corporations doing business in the U.S., through subsidiary or branch operations, to disclose the same consolidated financial statement data that the U.S. firms with which they are competing are required to disclose. This would produce a level playing field with respect to information disclosure. If a foreign firm wishes to do business in the U.S. only through completely independent distributors then there should be no reason to require this disclosure.

The consolidated financial statements should be required to contain an audit opinion, should be stated in U.S. dollars and the income should be measured using U.S. accounting rules. The U.S. has the most rigorous of all financial reporting requirements. **With the extensive globalization of the world economies, there is a tremendous need to have a uniform accounting system worldwide.**

Today with profits measured in various ways, there is no guarantee that the shifting of $100 in income from country A to country B will be reported as a $100 increase in income in country B. The tax law in country B may provide a special deduction based on or limited by a percentage of revenue or income, thus the $100 may result in an increased deduction of say $40 so that the $100 shifted from country A results in only $60 of increased income in country B. Even if the $100 appears as additional income to country B in year 1, prices may be changed on parts produced in other countries such that by year 2 the corporate entity may have "reshifted" the $100 from country B to a tax haven operation in a country such as Singapore. Since price changes can affect items over extended periods of time there is no guarantee that the $100 will remain in the country in which it is really earned.

The use of uniform accounting treatments for financial reporting would assist each country in enforcing its income tax laws in a more equitable manner. This would also greatly improve the value of financial statement information presented to shareholders.

Some countries, and especially Japan, normally require that special tax deductions also be taken for financial reporting in order to obtain the income tax deduction. For these countries the reported earnings in the annual reports to their shareholders are virtually meaningless. This can be seen in the lack of any close relationship between reported earnings or losses and stock prices for many Japanese corporations. The following data (in yen) was taken from page 3 of the 1989 Kawasaki Heavy Industries annual report to the Ministry of Finance:

	1985	1986	1987	1988	1989
Earnings per share	4.41	(2.74)	(11.68)	0.76	5.99
Yearly stock price:					
High	173	252	298	408	991
Low	136	149	150	230	367

The Need for a Uniform Measurement System -- Financial Reporting under Japanese Rules:

As a general rule, most Japanese corporations (those not listed on U.S. exchanges) do not prepare consolidated financial statements for their shareholders. Instead they show parent corporation statements only with subsidiaries accounted for under the cost method (reporting subsidiary income only to the extent of dividend income). This is totally inadequate and can produce very misleading results. In the U.S., the Financial Accounting Standards Board (FASB) does not even permit the use of the equity method in reports to shareholders for subsidiary corporations let alone the cost method.

In Japan the accounting rules are prescribed by the Ministry of Finance. In addition, the income tax rules often require a deduction to be taken for financial reporting in order to obtain the deduction for tax purposes. This tends to greatly understate and distort reported incomes of Japanese firms.

In addition to understating income the Japanese tax law produces double deductions for some expenditures. Under Japanese law when one corporation acquires the assets of another the amount paid for goodwill, if any, can be immediately written off. If, however, one corporation acquires the stock of another (rather than the assets) there is no deduction for goodwill. Thus, where there is significant goodwill, Japanese corporations will attempt to acquire the assets of Japanese target corporations rather than their stock. Under U.S. income tax law, goodwill (to the extent not reduced by creative intangibles) is not deductible in either a stock or an asset acquisition. Instead, goodwill may have a basis and be treated similar to land in that the basis is deductible only when the goodwill is sold or the business is abandoned. Goodwill is not depreciable.

When a Japanese corporation acquires a U.S. corporation there is a strong possibility of a double deduction. For example, Sony recently acquired Columbia Pictures in an acquisition that probably contained substantial goodwill. Under Japanese law, because Sony acquired the stock of Columbia, there would be no goodwill deduction. Under U.S. law, however, if Sony makes a section 338 election, the acquisition is treated as an acquisition of assets. Presumably, this allows Sony to immediately write off the goodwill on its Japanese tax return as though this were an asset acquisition. In the U.S., however, the amount paid for the goodwill is allocated among the assets using as many creative intangibles as can be thought of so as to obtain depreciation deductions on the U.S. tax return. When this happens the same cost is deducted on the Japanese tax return (a subsidy by the Japanese government) and also on U.S. tax returns. With this tax deduction subsidy by the Japanese government, it is almost impossible for any U.S. corporation to compete with any Japanese corporation in the acquisition of a U.S. target corporation.

It is indeed unfortunate that the Japanese government will subsidize the acquisition of U.S. corporations in such a fashion that other U.S. firms cannot compete. But one should not question the Japanese motivation, for it is up to the U.S. Congress to prevent such action by changing the U.S. tax law and not by complaining about the Japanese position. This could be done by merely requiring that when the tax laws of any foreign country provide such a benefit, an equal amount of income must be immediately reported and taxes paid on that amount without any offset by deductions or credits. This would allow U.S. corporations to compete in the acquisition of U.S. corporations on a basis that removes the foreign subsidy.

In Japan there is also a deduction permitted for the investment in a foreign subsidiary. This deduction generally may be taken when the subsidiary has reported losses. Thus Japanese tax law directly encourages the reporting of losses in foreign subsidiaries so as to obtain the write off of the "investment in the subsidiary" against the parent's Japanese tax return. Due to the special nature of the "investment in subsidiary" write offs they are also required to be taken for financial reporting purposes. Thus Kawasaki Heavy Industries shows a "foreign investment deficit reserve" in its annual report to the Ministry of Finance for year ended March 31, 1988.

Japanese subsidy of industry has been enormous and it is reflected in the fact that, like the U.S., their Federal Government is also operating at a deficit. A deficit that exists even though Japan has shown one of the most amazing growths in income and assets for any country at any time in history. Japan also has some other similarities to the U.S. beyond the deficit; they also have an extensive Social Security deficit problem on the horizon due to their baby boom growth immediately after World War II. But unlike most of the U.S., there is extensive income tax cheating especially by fishermen, farmers, and small businessmen. In other words, much like our country, most of the Japanese tax revenue is raised by a tax on labor both through the income tax and through social security taxes. Japan also has tax sparing arrangements with countries such as Singapore through which large amounts of revenue are shielded from Japanese taxation.

Japan is clearly not the only country in the world with special income tax laws. Certain countries do not tax interest, dividend or royalty incomes. Therefore, multinational corporations will try to finance their operation through Swiss subsidiaries, for example, such that a U.S. subsidiary may obtain an interest deduction for paying interest to a related Swiss subsidiary. In this case, there is no offsetting interest income being taxed in the country of receipt. In addition, the Swiss subsidiary can apparently pass the funds on to say a Japanese parent by merely loaning the U.S. payments to the Japanese parent. In which case, the Japanese parent would also obtain a deduction, on its Japanese tax return, for interest payments on the "loan" from its Swiss subsidiary. In the U.S. this would probably be recast as dividend income. The solution here is to completely disallow any expenses of producing tax exempt income (similar to section 265) regardless of where in the world the income is housed even if it is within a different but related entity.

Potential Solutions

Increasing Audit Effectiveness.--One possible solution to this problem is for the IRS to pool its best and brightest auditors and attorneys and form special audit and attorney teams to attack the large transfer pricing cases. This is a costly use of talent as these persons could be generating revenue by auditing for other types of aggressive tax behavior in which the potential success may be much higher, but it is doubtful if any area has more tax dollars involved than section 482 cases. Another solution might be the employment of outside audit teams on a contract basis to audit (perhaps with the assistance of IRS international examiners) the more aggressive multinational firms. There may be many CPAs who would like to aid their government in the audit of large multinational corporations.

Legislative and Administrative Improvements.--Another at least partial solution would be to improve on the section 482 measurement rules and to make it a fraud penalty to have overly aggressive income allocations. In addition, the settlement positions of the IRS should perhaps be modified so that it would be impossible for a taxpayer and the IRS to settle any section 482 case in which the taxpayer would be better off by settling than it would have been if the tax return had been properly prepared in the first place. This would require the collection of all penalty and interest payments and perhaps at an increased rate commensurate with what the firm would have had to pay to an outside banker for that borrowing.

As previously discussed, making the tax returns of all major corporations public information might go a long way in reducing the overly aggressive positions being taken on both in-bound and out-bound transactions.

A New Alternative Minimum Tax (AMT): The idea of a minimum income tax has become fairly well established within the U.S. income tax system and yet it seems to completely fail when applied to the income tax strategies of foreign owned U.S. subsidiaries. (It is of equal effectiveness when applied to out-bound transactions.) The alternative minimum tax works by adjusting reported taxable incomes (by removing some or all of certain deductions or adding certain income) to arrive at a new taxable income amount for the application of the alternative tax rate. It does not, however, adjust for the effects of overly aggressive transfer pricing.

What is needed in these situations is the application of an assumed rate of return on assets being employed in the U.S. Since foreign owned U.S. subsidiaries reported $840 billion in assets in 1986, an assumed 8%[5] before tax rate of return would have resulted in $67.2 billion of taxable income and a minimum tax rate of 20% would have produced $13.4 billion of minimum tax. The 46% regular income tax rate, as noted earlier, would have produced a tax before credits of about $30.9 billion.

In fact, a fixed rate of return minimum tax might even be substituted for the overly complex existing minimum tax. In applying this version of a minimum tax, safeguards could be worked out so that no corporation suffering real losses would be forced to pay an AMT on income it has not earned. The addition of a fixed rate of return on assets would significantly increase the income tax that most foreign owned U.S. corporations are paying but would not impact those corporations (domestic or foreign) reporting true or even realistic earnings. Even the Organization for the Fair Treatment of International Investment (OFTII) group in their paper prepared by KPMG Peat Marwick state that,

> "Assets and net worth provide indirect measures of the amount of income corporations will earn given a "normal" rate of return."[6]

Future Efforts

It has been my pleasure to present this testimony, and if I might be of any further help in solving this problem please do not hesitate to contact me. I firmly believe in our self-assessment system; but in order to protect it, we must eliminate as much of the understatement of income as possible.

Respectfully submitted by:
James E. Wheeler

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[1] For a more detailed discussion of the tax implications of both inbound and outbound transactions see, James E. Wheeler, "An Academic Look At Transfer Pricing In A Global Economy," Tax Notes, July 4, 1988, pp. 87-96.

[2] James R. Hobbs, "Foreign Investment and Activity in the United States Through Corporations, 1983," SOI Bulletin, Summer 1987, pp. 53-68; and Skelly, Daniel F. and James R. Hobbs, "Statistics of Income Studies of International Income and Taxes," SOI Bulletin, Fall 1980, pp. 25-40.

[3] For a more complete discussion of this problem see James E. Wheeler, "SEC Requires Less Disclosure From Foreign Corporations," Tax Notes, October 12, 1987, pp. 195-197.

[4] For the complete audit opinion see the Sony Corporation's Form 20-F as filed with the SEC for the year ended March 31, 1989, pp. F-2 & F-3.

[5] For those concerned about the rate of return percentage, we should note that it could vary and be worked off of the allowable federal rate. We should also not that waitresses are today subject to an 8% yield on gross receipts (under section 6053(c)(3)) as an estimate of true tip income.

[6] "Review of Internal Revenue Service Statistics on Taxable Income and Tax Liability of Foreign Controlled Domestic Corporations" prepared for OFTII by the Policy Economics Group of KPMG Peat Marwick, dated June 8, 1990, p.13.

Tables from SOI Data
(dollar amounts in millions)

Table 1
All Foreign Owned US Subsidiaries

Year	All Returns	Total Assets	Receipts	Income Less Deficit	Return on Assets	Distri-butions	Distrib / Receipts	Receipts Returns
1983	33,622	$530,334	$389,909	$1,849	0.35%	$4,327	1.110%	1159.7
1984	37,401	$552,598	$459,162	$4,528	0.82%	$3,322	0.723%	1227.7
1985	36,677	$655,696	$513,778	$2,978	0.45%	$3,529	0.687%	1400.8
1986	36,778	$840,893	$542,695	($1,519)	-0.18%	$5,568	1.026%	1475.6
1987	n/a	$959,400	$686,800	$5,600	0.58%	n/a	n/a	n/

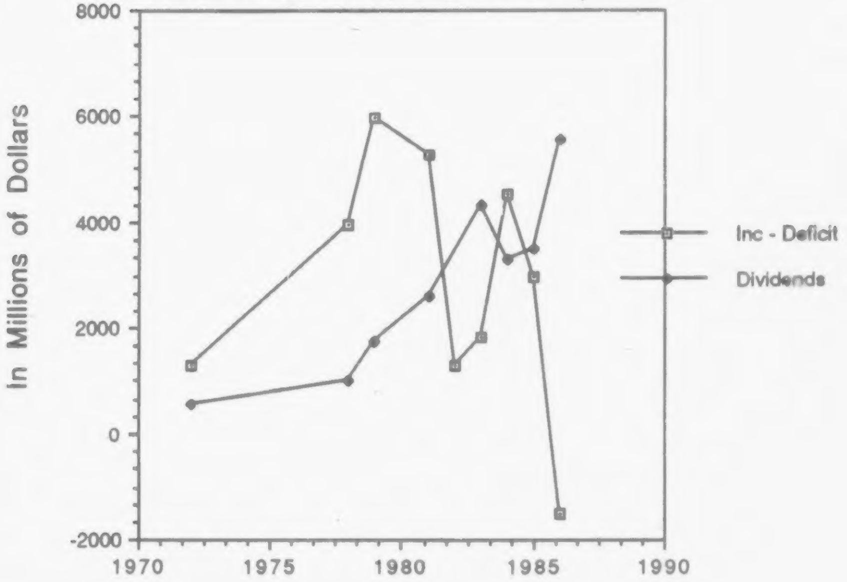
Table 2
All Foreign Owned US Subsidiaries With Income

Year	Returns	Total Assets	Receipts	Net Income	Return on Assets	Distri-butions	Distrib / Receipts	Receipts Returns
1983	13,648	n/a	$227,383	$12,448	n/a	$3,297	1.450%	1666.1
1984	15,306	n/a	$295,319	$15,356	n/a	$2,599	0.880%	1929.4
1985	15,882	n/a	$332,791	$14,500	n/a	$3,157	0.949%	2095.4
1986	14,348	n/a	$335,840	$12,745	n/a	$2,904	0.865%	2340.7
1987	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/

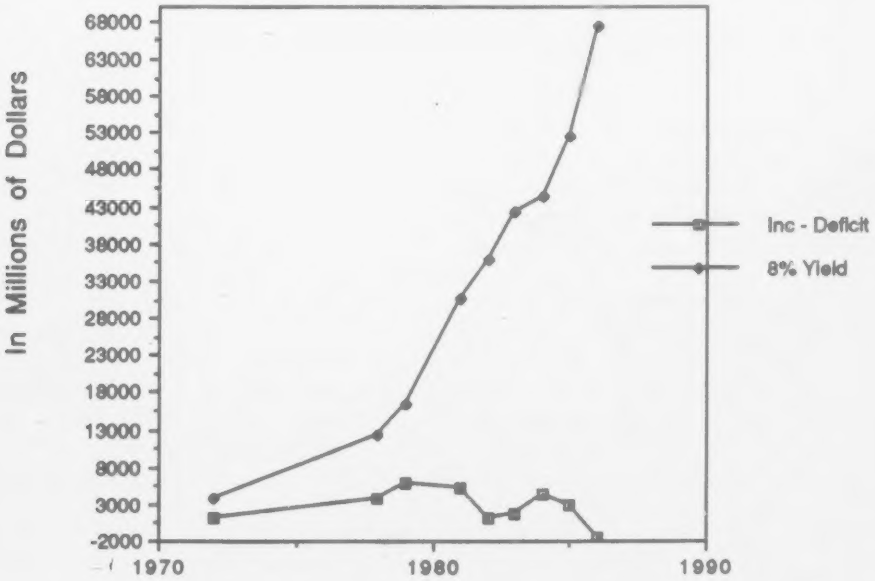
Table 3
All Foreign Owned US Subsidiaries With Deficit

Year	Returns	Total Assets	Receipts	Net Deficit	Return on Assets	Distri-butions	Distrib / Receipts	Receipts Returns
1983	23,753	n/a	$162,526	($10,599)	n/a	$1,030	0.634%	684.2
1984	22,095	n/a	$163,843	($10,828)	n/a	$723	0.441%	741.5
1985	20,795	n/a	$180,987	($11,522)	n/a	$372	0.206%	870.3
1986	22,430	n/a	$206,855	($14,264)	n/a	$2,664	1.288%	922.2
1987	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/

Graph 1
All US Subsidiaries of Foreign Parents
Income-Deficit to Dividends Comparison



Graph 2
Income-Deficit to 8% Yield Comparison



Mr. **McGrath**. Will the gentleman yield?

Chairman **Pickle**. Mr. McGrath, I will recognize you.

Mr. **McGrath**. The alternative minimum tax usually discounts preference items. How would yours work, a return on equity function?

Mr. **Wheeler**. Some of the problems I can see with using this type of a situation for alternative minimum tax, you might have to consider whether the company is debt or equity financed. If it is very heavily leveraged you might have to adjust for the debt equity. If a company has a lot of leases rather than owning assets then you might have to capitalize leases. That is done all the time for financial reporting.

It is also possible, thinking about some of the software companies where they are largely R&D companies, they don't have much in the way of fixed assets. But they have a lot of intangible assets. Well, that is only the growth and the value from their R&D. The way to capitalize that is to take the last 5 years' moving average R&D for purposes of this test. You can do it with R&D and also with advertising.

The value of advertising, increases the prestige of the company and the name, so you could have a moving average. It would be much easier than today's adjusting your taxable income by changing those preference items around.

Mr. **Flippo**. Would the gentleman yield? I would like to ask Mr. Egger a question. You seem to be suggesting that there is no way that the Service is going to be able to get enough resources to really deal with this problem through the 482 approach. Is that an accurate portrayal or your feelings?

Mr. **Egger**. That is my opinion, Mr. Flippo, because that is 5 years of experience plus some more years of observation. It has not happened. I just have some doubt that it is going to.

Mr. **Flippo**. That is pretty good evidence. That is true.

Mr. Gibbs, I appreciated your testimony very much, too. Would you tell me who should not be left out in any kind of international approach or round table approach to trying to fix 482?

Mr. **Gibbs**. Mr. Flippo, I can give you a start. I would say it should include, and perhaps with additions, representatives of our Government, the IRS, Treasury. I would also include representatives from our major treaty partners, because my pretax here is that this is really a global issue. If you don't bring the people in on the front end from the other countries, then you are going to hear about it on the back end. I would at least give them the opportunity to participate if they chose to do so. I would include representatives of—and I know this will get a bit tricky, but I would find a way to include—the multinational businesses, U.S. based or foreign based. I would have representatives like our two witnesses from academia who have background and interest in this area, to keep everyone honest and also to help us with some of the issues where I think they have real expertise to provide.

Mr. **Flippo**. The most important one we would not want to leave off that is Mr. Jake Pickle, our distinguished subcommittee chairman. We would want him on there.

Mr. **Gibbs**. That goes without saying.

Chairman **Pickle**. I was just thinking, you said you might include some of these multinationals. I started to say that would be the fox in the chicken coop. It might be even worse if you included some of us on it, I suppose.

Mr. **Granfield**. I think there are a lot of U.S. and foreign multinationals who are very concerned about those who are not playing on a level playing field and who want very much to have a level playing field, but also one that is not as complicated as the enforcement procedures today. A lot of U.S. and foreign firms feel very bad at being painted with the same brush of tax avoidance that some of these firms have engaged in.

Mr. **Flippo**. Would you have any thoughts about what Mr. Egger and Mr. Gibbs have said based on their experience about whether or not we will ever be able to put enough resources in to deal with it, from your experience serving as an economist in that area?

Mr. **Granfield**. I have to support a lot of what Roscoe said. I have never seen two 482 cases that look the same. That is not to say that I have not seen a 482 case that with the appropriate analysis that cannot be resolved effectively. I think we need not a broad brush approval, but a safe harbor, so those taxpayers who are not going to take a lot of resources of the IRS and their own resources can have some guarantee that there is some criteria. The arm's-length standard is not going to work on an international level anyway. We have to come up with an approach that is simpler for both the taxpayer and the IRS to understand.

I have been on panels that say every firm now will have to have an economist. That terrifies me. I don't think that is the solution to the problem. We have to have a more basic fundamental approach to this issue.

Mr. **Flippo**. Is there any doubt in your mind that they are going to continue to play the audit lottery?

Mr. **Granfield**. I don't see any evidence to that yet, sir, I am sorry to say.

Mr. **Wheeler**. The rate of return from playing the audit lottery is so high that we are almost forcing it on them. Some of the settlements in some of the cases where the IRS has been successful have probably been less than the tax they would have paid had they paid it properly. Well, if you have that situation you are just encouraging them. Then what about the ones where the Government was not successful?

Mr. **Gibbs**. Mr. Flippo, I would respond this way: I would certainly hope that we could find a way to do things simpler, but frankly in this area I must say I have as much skepticism about simplicity as I do about finding the dollars to do it. I urge folks not to try to sell this on the basis that you will come up with something that will eliminate the need for more resources in the IRS.

Mr. **McGrath**. If you will yield, we have been working on the Select Revenue Measures Subcommittee on the section 809 problem with the mutual and stock life insurance company. Then we have this. It is sort of overwhelming, section 2036(c) and a bunch of others. The complexity of all those sections of the law almost drives me to the point where I would say, hey, let's have a gross receipts tax, let's have a gross premium tax on life insurance, just to get away from the complexity to which we have driven ourselves.

You were hypothesizing about simplicity. I wonder how simple we can make this. We dealt with a flat tax 10 years ago. I wonder whether or not after living through these things for the past 10 years now in this committee, that it might be the right way to go.

Mr. **Granfield**. I think it really depends on what our trading partners are willing to do. There is only one pie they are dividing up. It depends on how much we can negotiate out without everyone saying, thinking they are going to have a system that allows their corporations to take a larger share of the pie or they will live in a world with a level playing field. It is similar to the trade negotiations.

Chairman **Pickle**. Let me interpose this thought. Part of this hearing is to determine whether foreign multinationals are paying their share of the taxes or are they using the transfer pricing system as a device not to pay taxes, and how could we can improve compliance. The purpose of the hearing is not to be recommending that we go to gross receipts tax or value added tax or any combination. That time may come, but not at this hearing.

Mr. **Flippo**. We are talking about transfer pricing here. Generally we are talking about manufactured products. But we all know that now we are looking at finance, insurance, banking, what else, pharmaceuticals——

Mr. **Gibbs**. Services.

Mr. **Flippo**. It is so serious and of such magnitude that we really do have to get our arms around this problem somehow or other because otherwise the entire economic structure can be destroyed.

Mr. **Egger**. Mr. Flippo, my comments also went to the question of the efficiency of the examination process. Right now, the way we are doing it is quite inefficient.

Mr. **Flippo**. Is there any more important area to apply our resources where we might get a greater return on our investment than in this area?

Mr. **Wheeler**. There may be a lot of them. By the time you put the resources in and you get that case all the way through to resolution, that time could have all been spent on tons of real little things, but in total they may have added up to more dollars.

Mr. **Gibbs**. Mr. Flippo, having attended hearings the day before yesterday and today, one of the things that was not lost on me was the media attention, the crowd attention, and the people that we had testifying today. All of that tells me, I think, that this is an issue that is going to play on in this country. I don't think it is an issue—the way it once was—of interest to those outside the country. I think we are seeing global competition in a way that we have not seen it previously. I think it is coming across the country. I would simply say that, in terms of the importance of this to the men and women in the United States, it is a very important issue.

Mr. **Flippo**. Is the industrial policy of other countries involved in these thrusts to spot given industries?

Mr. **Gibbs**. I didn't understand your question.

Mr. **Flippo**. I am saying is this a part of other country's industrial policies——

Mr. **Gibbs**. I don't know.

Mr. **Flippo** [continuing]. To take over?

Mr. **Egger**. I think it is crystal clear that the Governments around the world are very much involved in the whole business of competition, if you will. This is not just as we think of it historically as happening in the private sector out there, but the Government is involved.

Mr. **Granfield**. I think there is a recognition that what you want to do is subsidize your international competitors. If you are French you are now going to favor your firms that are going to be international competitors. One of the ways to do that, one of the complicated ways to do that is to use the Tax Code to do that. I think they are much less sensitive to this issue than we are, but they are going to get sensitive to it in the next 5 to 10 years. I think this will be the major economic problem for the next decade.

Mr. **Wheeler**. Going back to the question about the resources, sure you can raise as much money elsewhere, but you cannot work on anything as important as 482. Singapore has a 32 percent tax rate but they have a zero rate if you will put in the type of business that they want to attract. Right now they want to attract R&D industries. If you will come in and put in a big R&D high-tech plant, then they will give you a tax holiday. Otherwise your tax rate is 32 percent versus zero.

So the answer is yes to your question.

Chairman **Pickle**. I don't know whether the other nations have ever intentionally set about as a matter of their own nation's industrial policy to cause this discomfort to us. The net effect, though, is that it has affected our industrial policy. We are losing jobs and industries. You have to ask yourself sooner or later who is going to own the industries in this country. I think it is a serious problem for us.

I want to thank the panel. You have been kind enough to wait during the day. You are experts in the field. I notice Mr. Gibbs and Mr. Egger both have been a little more cautious about things we ought to specifically recommend, because you have lived in the trenches and you are a little more hesitant to talk big and walk loud, but you both realize this is a very serious problem. We need more information and 482 is not working, at least Mr. Egger, you said you have been waiting for it to happen and it just has not come about.

I think there is a general admission on all your parts that 482 is not functioning properly. Professor Wheeler and Dr. Granfield said it is not working. I hope this committee will advance some changes. I am encouraged by the response of the Treasury Department today that they will agree to some of these changes.

In addition, seems to me that there is a great deal to be gained from the Department to get a blue ribbon commission to look at this on a broad basis. Nearly every one of you have recommended that approach. I think that is noteworthy because then you would have a broad participation, even multinationals perhaps on it. We might use that approach in much the same basis as we did with civil tax penalties that some of you helped on that turned out to be a successful story for this committee and for the country.

If we can do that and at the same time get more information—and each one of you seems to say that is the key, more information. I believe that is correct. We need it. Perhaps we need to go as far as Dr. Wheeler said and establish some kind of a uniform international accounting system. There are other approaches we could take.

I personally find that the facts that you have given are satisfying to me and this committee. I guess I was personally impressed with Dr. Wheeler's comments when you said the loss might be $30 billion and that was at the bottom. Some of the people today hesitated to accept something like that because that might be a little outlandish and we ought not to give the hope that we could get that much money.

You say it is the bottom. Whatever the figure is, it is sizable. Section 482 is not working well. There needs to be a commitment on the part of the administration and the Congress, and business together, that we can correct this 482 procedure or this pricing game, because it is not working well for us. It is working well for the multinationals but it is not working well for the United States, except to the extent that we can say we have businesses over here. We are selling a lot of automobiles but we are going down the drain in the process.

So I would say to you that your testimony has been very helpful. I appreciate very much your giving us these recommendations.

Mr. McGrath.

Mr. McGRATH. I thank the Chairman. I too want to compliment the panel. We probably received more solid recommendations from this panel than the others we had before us, other than the field people from the IRS.

At this point, Mr. Chairman, I would like to compliment you and the subcommittee staff and the Joint Tax Committee for giving the preparation necessary to develop this hearing. It has been an investigation that has been certainly well worthwhile. It raised an issue of interest certainly to those of us who are on the committee and off the committee, and even throughout the Congress. This is of interest to people who are not on this particular committee. The fact that you have taken a lead in raising this issue is commendable.

Thank you for giving me the opportunity to work with you on this.

Chairman PICKLE. I appreciate that, Mr. McGrath. I want to join in giving my compliments to the staff. I believe this is the most extensive, substantive indepth examination of tax avoidance involving 482 section that has ever been put together in the history of our tax laws. It is commendable that we have approached it from that standpoint. I think something good can come from all this. I hope that we have done it in a professional manner and it will be productive for us.

I thank you again for your testimony.

The committee will stand adjourned.

[Whereupon, at 4:30 p.m., the hearings were adjourned.]

[Submissions for the record follow:]

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August 16, 1990

The Honorable J.J. Pickle
House Ways and Means Committee
242 Cannon House Office Building
Washington, DC 20515

Re: Oversight Subcommittee Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Companies

Dear Mr. Chairman:

I am the Chair of the American Bar Association Section of Taxation and am writing regarding the above-referenced hearings. This letter and the attached comments are submitted on behalf of the American Bar Association and its Section of Taxation. I respectfully request that this letter and the attached comments be included in the official published record of the hearings.

First, we would like to commend you and the Subcommittee for addressing this important issue in a straightforward manner and for soliciting detailed comments from the Department of Treasury and the Internal Revenue Service. To the extent that there is concern that foreign taxpayers may be underpaying their taxes in the United States, we fully agree that the problem should be carefully scrutinized. Furthermore, to the extent that it is determined that certain foreign taxpayers are in fact underpaying their taxes in the United States, appropriate adjustments should be proposed consistent with applicable legal principles and the particular facts and circumstances involved.

We are not in a position to assess the data and information that the Subcommittee has received on individual taxpayer cases. Based on our experience, we know that cases involving transfer pricing issues are intensely factual in nature. Accordingly, we would urge the Subcommittee to move cautiously in extrapolating broad conclusions or generalizations from the specific taxpayer data presented in connection with the hearings.

Both Assistant Secretary Gideon and Commissioner Goldberg testified that additional audit and enforcement measures -- as opposed to legislative changes to section 482 -- should be the current focus of the Government's attention in this area. We concur with this conclusion. We specifically recommend that Congress provide the IRS with sufficient resources to determine the extent of, and to correct, non-compliance by foreign-owned companies doing business in the United States. We also note that there have been several recent changes in the law in order to improve compliance by foreign taxpayers doing business in the United States. As indicated by Assistant Secretary Gideon and Commissioner Goldberg, we also believe that these recent legislative changes affecting tax compliance by foreign-owned companies should be given adequate time for implementation. We also support the request by Commissioner Goldberg and Assistant Secretary Gideon that certain provisions be added to Sections 6038A and 6038C of the code to encourage taxpayers to provide the IRS with additional information, with certain modifications to be addressed in our comments on the Foreign Tax Equity Act. These comments will be submitted shortly.

In short, we share your concern that there may be an underpayment of U.S. tax by foreign taxpayers. We do not believe, however, that it would be appropriate to replace the arm's length standard that is utilized by the United States and most other countries. Any change in the arm's length standard must take into account not only the impact on inbound transfer by foreign-owned companies but also outbound transfers by United States-owned businesses. Most of our trading partners are at least equally concerned as we are about the proper application of the arm's length standard for inbound and outbound commerce. Accordingly, we recommend that the Subcommittee urge the Treasury Department to commence multilateral discussions with our trading partners concerning transfer pricing rules.

The ABA Tax Section would be pleased to work with the Subcommittee. Please do not hesitate to contact me if we can be of assistance in any way.

Very truly yours,

Jere D. McGaffey

Jere D. McGaffey
Chair, Section of Taxation

cc: Subcommittee Members

7031M

STATEMENT ON BEHALF OF THE AMERICAN BAR ASSOCIATION SECTION OF TAXATION

SUBMITTED TO THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES REGARDING COMPLIANCE BY MULTINATIONAL BUSINESSES WITH TRANSFER PRICING PROVISIONS OF SECTION 482 OF THE INTERNAL REVENUE CODE

On behalf of the American Bar Association and its Section of Taxation, we offer the following comments regarding compliance by multinational businesses with the transfer pricing provisions of Section 482 of the Internal Revenue Code. The Chairman and the Members of the Subcommittee deserve much credit for addressing this important subject, focusing broad attention on it, and illuminating it in the hearings that were held last month. As those hearings indicate, the transfer pricing topic is complex and involves international relations as well as tax, trade and economic policies. Although there are no easy solutions to many of the issues raised and discussed during the hearings, we look forward to working with and assisting the Subcommittee and staff as they continue to deal with these issues.

RECOMMENDATIONS TO DETER NON-COMPLIANCE

The testimony presented by the staff of the Subcommittee and representatives of the Internal Revenue Service and the Treasury Department strongly suggests that there has been a significant degree of non-compliance with the transfer pricing provisions of Section 482 by certain taxpayers in specific industries with respect to products manufactured abroad and sold in the United States. That situation is unacceptable. All taxpayers doing business in the United States should pay their fair share of tax. Steps should be taken to remedy any non-compliance with the transfer pricing provisions of Section 482 -- whether the taxpayer is owned by United States or foreign persons.

Specifically, we recommend that Congress provide sufficient resources to the Internal Revenue Service to permit IRS to determine the extent of, and to correct, any non-compliance by foreign-owned companies doing business in the United States. The additional resources should be used by IRS to employ, properly train and retain qualified, experienced examiners who can develop the necessary expertise to cope with the complex, sophisticated issues involved in transfer pricing arrangements. The increasing complexity and sophistication of these arrangements mirror the increasing complexity and sophistication of international business transactions. To cope with these economic realities, we recommend that the relatively small staff of IRS international examiners be increased and that the compensation of these specialists be increased to levels much closer to the salaries paid similar specialists in the private sector. We also recommend that funding be provided to IRS to permit continued training of such specialists to enable them to stay abreast of the constant, intricate changes occurring in the international business community and in the tax rules applicable to international transactions.

We join in the request by Commissioner Goldberg and Assistant Secretary Gideon for Congress to provide additional resources for the further purpose of enabling IRS to employ expert consultants to assist IRS international examiners in analyzing transfer pricing transactions to which Section 482 may be applicable. It is important and often difficult for IRS examiners to know what type of factual information they should develop in transfer pricing cases unless they have the assistance of experts. To the extent that government procurement rules make it difficult for IRS to employ expert consultants, those rules should be changed to facilitate timely employment of qualified consultants.

An immediate and critical first step toward these increased levels of IRS funding presents itself in the pending Treasury Appropriations bill for fiscal 1991. The House bill includes a very considerable -- and appropriate -- increase in IRS funding for that year. The bill reported by the Senate Appropriations Committee fixes a seriously lower increase for the IRS. It appears likely that the Senate Committee bill will be approved by the full Senate in early September, without material change in the IRS appropriation, and go quickly to Conference.

We intend to state strong support of the House position to all Conferees on behalf of the American Bar Association and the Section of Taxation. We intend, further, to specify for the Conferees the grounds upon which our support rests. We urge the Chairman and the Oversight Subcommittee to continue their important and long-sustained leadership on this issue by working in every way possible to sustain the House position in Conference.

Beyond supporting the IRS request for additional funding to obtain the necessary human resources for transfer pricing examinations and enforcement, we join in the recommendation by Commissioner Goldberg and Assistant Secretary Gideon to amend Sections 6038A and 6038C of the Code to induce taxpayers to provide IRS international examiners and outside experts with factual information necessary to permit the IRS to make informed judgments about whether particular transfer pricing arrangements meet the arm's length test applicable under Section 482. Because of the competitive sensitivity of much of this information and the different standards applicable to protect disclosure of such information in other countries, however, we urge Congress and IRS to take particular care to assure the continued confidentiality of such information. We also will recommend certain other modifications of the Foreign Tax Equity Act in comments to be submitted shortly.

In addition, we encourage IRS to explore internal procedures to facilitate resolution of transfer pricing cases at the earliest time and at the least cost possible. The recent IRS advance determination procedure is a step in the right direction, although care must be taken to avoid procedures that are too costly or burdensome to be effective. We encourage IRS to continue to develop and explore such concepts and to consider their usefulness in disposing of pending cases involving prior years. The point is clear: if taxpayers are to be encouraged to provide IRS with relevant information at the earliest possible time, the IRS has a corresponding obligation to develop procedures to use such information to expedite the dispositon of transfer pricing cases.

THE ARM's LENGTH STANDARD IN SECTION 482

Based on information and testimony provided during the July hearings, we are concerned about suggestions that the arm's length test should be replaced as the standard to determine the propriety of transfer prices. The arm's length standard is generally accepted on a worldwide basis as the appropriate transfer pricing standard. It is conceptually incorporated in many of our treaties with other countries, and it reflects the tax neutrality that has been the hallmark of the United States tax and trade policies with other countries for many years.

Unlike our above recommendations, the suggestion that replacement or modification of the arm's length standard should be considered was not generally agreed to during the hearings.

Both IRS and the Treasury Department, as well as other witnesses, expressed concern about any such change. We agree. We strongly believe that more information on the extent of and reasons for non-compliance needs to be developed before Congress alters the generally accepted world-wide standard for transfer pricing.

For example, it has been suggested that the relationship of effective tax rates in the various countries in which a multinational taxpayer is operating may affect the transfer pricing of the taxpayer. It is suggested that multinational taxpayers may compare the effective tax rates of the countries in which they are operating and then arrange their transfer prices so that most of their income is taxed at the lowest effective rate. See Joint Committee on Taxation, "Present Law and Certain Issues Relating to Transfer Pricing (Code Section 482)" (JCS-22-90) at pages 22-23 (June 28, 1990). It has, conversely, been suggested that taxpayers in certain countries under certain circumstances elect to pay apparently higher effective rates for a variety of reasons. Furthermore, most of the statistical data developed and presented at the hearings involved transactions occurring before complete implementation of the relevant provisions of the Tax Reform Act of 1986. Because of the substantial reduction in the United States marginal corporate tax rate made by that Act, further analysis seems appropriate to determine the relative importance and operation of tax rates and other relevant factors as they affect transfer pricing arrangements by multinational businesses.

Equally important, as also suggested during the hearings, any change in arm's length standard under Section 482 must take into account not only its impact on inbound transfers of goods and services by foreign-owned companies but also outbound transfers by United States-owned businesses. Several witnesses during the hearings suggested that the 1986 Act changes adding the so-called "super royalty" provisions to Sections 482 and 367(b) may represent an inappropriate departure from the arm's length standard. Although the changes appear to have been directed at potential tax avoidance by outbound transfers of United States-owned multinational companies, the testimony suggested that when the super royalty provisions are applied to inbound transfers of technology, they might well lose revenue. The fundamental point seems plain: transfer pricing rules apply to both inbound and outbound transactions. Principles of tax neutrality require that those rules operate the same way whether the transfers are inbound or outbound. It would seem inappropriate -- and could be detrimental to the United States tax base -- to make changes to "protect" the U.S. tax base for inbound transfers if those same rules result in U.S. revenue loss for outbound transfers.

History suggests that any changes which the United States may make in the way it taxes the income of foreign-based businesses operating in the United States are likely to be emulated by other countries dealing with United States businesses operating in those countries. Hence, before any changes are made in the transfer pricing rules affecting foreign companies operating in the United States, careful consideration must be given to their impact on United States companies operating abroad.

Carrying forward this analysis, we note that many of our trading partners are at least equally concerned about transfer pricing issues. Indeed, we gather that the British Chancellor of the Exchequer has written Treasury proposing multilateral discussion of these problems. Because of the important role of such discussions in the overall analysis of this area, we recommend that the Subcommittee urge Treasury to begin such discussions promptly and proceed with them with dispatch. We further recommend that Treasury work closely with the Subcommittee and other appropriate bodies of Congress as the talks go forward.

CONCLUSION

In conclusion, we recognize the considerable importance of transfer pricing issues to our tax system, and we congratulate the Chairman, the Members of the Oversight Subcommittee, and its staff for the critical work on these issues they have so well begun. We strongly recommend that Congress provide IRS the resources it requires to determine the extent of and reasons for non-compliance in this area and to correct such non-compliance as is found to be present. We further recommend that Congress take a key first step in this direction by adopting the House position on funding of the IRS in the Conference on the Treasury Appropriations bill for fiscal 1991. We join in the recommendations of Treasury and the IRS that Code Section 6038A and 6038C be amended to induce taxpayers to provide the IRS the factual information necessary for informed evaluations of transfer pricing arrangements, subject to certain modifications that will be submitted in our comments on the Foreign Tax Equity Act. Underscoring the broad multinational use of the arm's length standard and the double-edged effect of modification of that standard, we recommend careful further development of relevant information before the standard is changed. For that and other reasons, we recommend that Treasury begin at once multilateral discussions of the transfer pricing subject and work with the Oversight Subcommittee and other appropriate Congressional bodies as those talks proceed.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE BEFORE THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, FOR THE WRITTEN RECORD OF THE JULY 10 AND 12, 1990 HEARING ON TAX UNDERPAYMENTS BY U.S. SUBSIDIARIES OF FOREIGN COMPANIES AND RELATED ISSUES

The over 250 corporate members of the American Petroleum Institute (API), a trade association representing all segments of the petroleum industry, welcome that the Subcommittee on Oversight (Committee) has made the U.S. tax posture of, and compliance response by, U.S. subsidiaries of foreign corporations the topic of this hearing (Hearing). However, while API members, as all U.S. taxpayers, support all reasonable efforts to assure that foreign owned enterprises pay the U.S. taxes due on their U.S. operations, API members believe that such efforts must not violate internationally accepted host country taxation standards.

Since the Hearing concerns all aspects of the U.S. tax posture of foreign controlled domestic corporations (FCDC), API urges consideration of its concerns regarding H.R. 4308, the Foreign Tax Equity Act of 1990 (Bill), introduced by Chairman Rostenkowski on March 20, 1990. The Bill and the statements or comments made in conjunction with its introduction address some fundamental precepts of the taxation of international operations.

In the long run, in API's view, the proposed special compliance rules for FCDCs, the taxation of certain nonresident alien stockholders on the gain of disposition of U.S. corporate stock, and the transfer pricing rules discussed in comments accompanying the release of the Bill, if adopted, would be detrimental to the interests of the United States and U.S. based taxpayers. If applied reciprocally by other countries, U.S. taxpayers inevitably would become subject to double taxation (given current U.S. sourcing rules) and cumbersome, inefficient compliance burdens. Moreover, the proposals appear to be inconsistent with long-established norms of international taxation by industrialized countries.

I. U.S. TAXATION OF NONRESIDENT SHAREHOLDER'S GAIN

A. The Legislative Vehicle

The Bill would tax gain or loss upon dispositions by foreign "10-percent shareholders" of a U.S. corporation by treating the gain or loss as effectively connected with the conduct of a U.S. trade or business (new Internal Revenue Code [Code] section 899) and, further, by treating such gain or loss as from U.S. sources, notwithstanding the sourcing rules introduced by the Tax Reform Act of 1986 in Code section 865.

With respect to the administrative enforcement provisions, the accompanying statement suggests that, beyond the provisions of the Bill, "consideration may be given" to the establishment of a presumptive rule which would provide

> that in determining the taxable income of a U.S. corporation from the sale of property acquired from a foreign person, a transfer price would be used that results in the U.S. corporation having taxable income from the sale of not less than 50% of the combined taxable income of the U.S. corporation and any related person from such property, unless the taxpayer proves otherwise to the satisfaction of the Secretary of the Treasury.

B. U.S. Policy in General

Prevailing Theories

As discussed in a recent Joint Committee on Taxation Staff report (See, Joint Committee on Taxation, Background and Issues to the Taxation of Foreign Investment in the United States (JCS-1-90), January 23, 1990, 59-64), under the principle of capital export neutrality, income from assets invested in a country of residence is taxed at the same rate as income from assets that are invested abroad; the tax rate on income from an asset depends only on the residence of the owner and not on the location of the asset. This position reflects a "global perspective" of the country of residence. Conversely, under the principle of capital import neutrality, income from capital would be taxed on the basis of where it is invested, regardless of the residence of the investor. (Id., at 59)

The Joint Committee Staff report notes that many regard the U.S. tax system to follow capital export neutrality in taxing capital owned by its residents (id., at 60). Under the international tax systems, as evolved, the source country imposes the primary tax, and the residence country either allows a tax credit or exempts the foreign income from tax. This system "generally displays properties that lie between capital export and capital import neutrality." (Id., at 61)

As further observed by the Joint Committee Staff report, a nation may have an incentive to impose a tax without regard to a tax credit in the residence country if the amount of foreign investment in the taxing country is relatively tax insensitive. The Staff explains that, although beneficial in the short run to the taxing country,

> a 'beggar thy neighbor' policy, if adopted by all countries, may leave all countries worse off than they would have been if the additional tax on income from foreign-owned capital had not been imposed. (Id., at 60)[1]

U.S. Principles

An enduring feature of the U.S. taxing jurisdiction has been to tax the income of U.S. citizens and resident corporations on their worldwide income. Conversely, in general since 1966, U.S. taxation of non-resident aliens and foreign corporations has extended only to income effectively connected with the conduct of a trade or business in the United State or to gross basis taxation of certain types of income, generally regarded to have few expenses associated with it.

Perhaps the longest standing principle of international taxation, generally followed by United States taxation of transactions between related parties, is based on an arm's-length standard. No industrialized country taxes on another basis. It is a common and central feature of tax treaties worldwide. It is reflected in the OECD Model Tax Convention and in the U.S. Model Tax Treaty.

The Bill

The Bill's Technical Description does not discuss the legislative rationale for the imposition of a tax upon stock gains of 10 percent foreign shareholders, but the statement accompanying the Bill reflects a desire to permit resident taxpayers to compete fairly with foreign investors. The rationale behind consideration of a presumptive rule of a formulary approach for transfer pricing arrangements is apparently a desire to enhance the enforcement powers of the Internal Revenue Service (IRS).

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[1] The report notes the parallel to 'beggar thy neighbor' tariff policies appropriately in an accompanying footnote.

C. Impact of the Bill

The imposition of a tax on the disposition of stock in a U.S. company by foreign taxpayers not having any connection with the U.S. other than the ownership of the stock of the U.S. corporation appears misguided and, in the long run, against the interests of the United States. With respect to investments by U.S. based taxpayers operating internationally, the United States exhibits strong tendencies toward capital export neutrality: taxpayers making outbound investments are taxed on their worldwide income (subject to allowance of foreign tax credits) with the primary jurisdictional basis of taxation being their residence. On the other hand, with respect to U.S. corporations' stock investments by foreign-based shareholders, the Bill would take a major step toward capital import neutrality: with respect to such inbound investment, the U.S. would impose its income tax based upon the location of the investment. As a result, the U.S. would extract revenue from taxpayers "coming and going".

These inherently conflicting policies, if adopted by other countries, will result in chaos. The primary losers will be the nations themselves. If other countries adopt residence-based taxation for outbound investment and source-based taxation for inbound investment, U.S. taxpayers investing abroad will be inevitably subject to double taxation. For example, capital gain realized by a U.S. taxpayer upon the disposition of a 10 percent owned foreign corporation is, in most instances, considered U.S. source (see Code section 865(a); cf. section 865(f)). If the country of the foreign corporation's operations imposes a tax as proposed in the Bill, the U.S. taxpayer will end up with U.S. tax on the gain at 34% and foreign tax on the gain at the prevailing foreign income tax rate. Since the gain is U.S. source for U.S. tax purposes and foreign source for foreign country tax purposes, no foreign tax credits are available, and double taxation results.

Turning to the apparent rationale for the Bill, the perceived competitive advantage of a foreign investor must be premised on the assumption that the country of residence does not also impose a tax on the disposition of the shares. This assumption appears questionable. The above referenced Joint Committee Staff report reflects that over 90 percent of the investment in the United States is made by European, Japanese or Canadian investors (Id., Table 4, at 10).

Looking at the countries whose residents are the most significant investors in the U.S. (i.e., the United Kingdom, Japan, Canada, West Germany, France), as reflected in another recent Joint Committee Staff study, all tax capital gains, with the possible exception of West Germany which taxes short-term but not long-term gains (Joint Committee on Taxation, Tax Treatment of Short-Term Trading, 31 et seq., JCT-8-90, March 19, 1990). In the case of West Germany the issue is moot since taxation of capital gains upon stock dispositions are clearly within the scope of the U.S.-West Germany treaty. The priority of this treaty is recognized by the legislation through the treaty reservation provisions.

Taxation of disposition gains by nonresident investors is contrary to today's trend toward removal of formal and informal, legal or economic, barriers to international investment and trade. Direct investment by foreigners contributes to desired global economic integration, increases productivity, entails possible technology transfers, and creates new jobs (for example, cf., Statement by Treasury Secretary Brady before the House Ways and Means Committee, Hearing on Eastern Europe, European Community, and Foreign Investment in U.S., April 18, 1990). The philosophy inherent in the Bill appears to be an unwarranted step by this country toward a "beggar thy neighbor" approach to income taxation which would construct a significant barrier to international investment and trade.

While the revenue estimate for all provisions of the Bill is close to $1 billion over the next five years, of this amount less than $100 million would be attributable to the extension of U.S. taxation to 10 percent foreign shareholder gains (based on estimates under the 1989 Bill which did not contain a treaty coordination provision). Such revenue gain does not justify a taxation measure which not only conflicts with the rationale underlying the current tax system and modern trends of global integration, but may be taken also as an affront by important political and trading partners of the U.S.

Two final points related to the foreign shareholder tax: First, if the experience with the FIRPTA[2] withholding is any indication, the additional burden in tax compliance will not be as minimal as envisioned in the Bill's Technical Description. It will be burdensome on domestic and foreign taxpayers alike. Second, while the bill permits losses to be allocated to U.S. sources, the practical value of obtaining the benefit of such losses by taxpayers not otherwise engaged in a trade or business in the U.S. and not permitted to consolidate their operation with affiliates with U.S. source income is open to question. The ability to secure any tax benefit from losses may well prove illusory.

Also, the presumptive transfer pricing rule noted in the Bill's accompanying statement, if implemented, would constitute an unjustified deviation by the United States from international norms of taxation. Taxation of international operations of related taxpayers based upon arm's length principles has prevailed because it achieves the correct result. Formulary methods can result in arbitrary shifts in the burden of taxation which have little to do with the contribution by a taxpayer's particular activity. As noted above, the Treasury Department and the IRS have consistently rejected a formulary approach to transfer pricing (e.g., Department of the Treasury, Study of Intercompany Pricing Rules, 53 F.R. 43522 et seq., Oct. 1988).

II. EXTENSION OF STATUTE OF LIMITATIONS, RECORDS RETENTION

A. Practical Compliance Limitations Regarding Records' Availability

As proposed, the Bill would apply Code section 6038A to all open years of a FCDC, without exception. The Bill fails to take into consideration ownership changes which may have occurred since the subject audit year. Neither the FCDC nor its shareholder(s) may have any current relationship with a person who was a related party at the time of the audited transaction. Therefore, the FCDC's ability to require the formerly related party to maintain records or submit, through an agency relationship, to a summons by the IRS may not even theoretically exist.

The Bill would subject a related party to the recordkeeping and summons rules of Code section 6038A, even where the FCDC was not 25% foreign owned during the audit year. Furthermore, the Bill does not make allowance for the a change in the identity of the 25% foreign shareholders between the audited year and the year of the audit.

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[2] Foreign Investment in Real Property Tax Act of 1980.

Any requirement of a related party to provide records should take into account such ownership changes.

B. IRS's Authority to Unilaterally Extend Statute of Limitations

To grant the IRS the power to unilaterally extend the statute of limitations with a respect to a "foreign related deficiency"[3] would destroy the balance between taxpayer and IRS, as well as defer inequitably the certainty and finality which follows from the regular statutory period's expiration.

This proposed grant of power goes beyond what was advocated by the IRS[4] during the consideration of the OBRA 1989 as necessary for an effective audit program: the IRS then sought relief from an inability to obtain records because the requested data were not kept in the desired format, not because of a failure to be provided on a timely basis if available.

Under the current practice, the IRS frequently does not schedule an audit until the regular limitations period is close to expiration. This delay is exacerbated by staffing deficiencies, pursuit of unproductive issues, and failing to reach timely decisions on the issues ultimately pursued. If audits were commenced and pursued on a timely basis, the current statute of limitations, with its symmetrical treatment of taxpayer and IRS, would suffice even in the case of FCDCs.

If the IRS should be given the power to extend the limitations period audits, will be prolonged unnecessarily. As proposed, the statute could be extended by the IRS despite a taxpayer's cooperation; the extension could undermine the IRS's incentive to efficiently manage audits in a timely manner. Although the Bill includes judicial review of the IRS extension, taxpayer's protection is somewhat illusory. During the review process, the running of the limitation period is suspended; thus, the IRS is guaranteed additional audit time irrespective of the merits of the extension request.

This imbalance could be alleviated if the district court had to hear the case on a priority basis, *e.g.*, within five days of taxpayer's filing, with the decision being final. The issue before the district court would be whether taxpayer's conduct prevented a timely audit and assessment, a fact question which is primarily within the province of the district court. The decision would be appealable only in extraordinary circumstances. Also, to avoid the grant of an unjustified extension of the audit period, the audit should be suspended for the duration of the court proceedings.

It would be preferable to address the problem of a dilatory taxpayer directly by enacting a more responsive procedure: instead of a unilateral extension of the statute of limitations, a suspension of the running of the statutory period, including a suspension of the audit, for the duration of summons enforcement proceedings could be substituted. The need for an extension would be reflected in the resort to adjudication, similar to the suspension provided in Code section 7609(e) with respect to third party summonses.

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[3] A "foreign related deficiency" results from a transaction between an at least 25% foreign owned domestic corporation and a foreign related party, or a deficiency of a foreign corporation with respect to taxes imposed by sections 882 and 884.

[4] The administration very recently opposed such a unilateral extension of the statute (Assistant Secretary of Treasury for Tax Policy Ken W. Gideon on June 21, 1990, in an address to the National Chamber Foundation, as reported in 47 TAX NOTES 1552, *et seq.*, June 25, 1990)

III. CONCLUSION

API believes that the imposition of a tax upon the disposition of shares in a U.S. corporation by a nonresident alien or a person not engaged in a trade or business in the United States through a fixed place of business should be dropped from consideration.

Further, API wishes to reaffirm and restate its long-held view that the standard of measure used by the United States (or for that matter, by any other nation) for the taxation of income of foreign persons in a related party context should be based on "arm's length dealing" and not upon a formulary method of taxation. The Treasury Department, the IRS, and the partners to treaties with the U.S. have consistently rejected a "unitary" or "formula" approach to transfer pricing.

API welcomes the Committee's review of the U.S. operations of foreign owned enterprises, with a focus on mechanisms which will assure proper U.S. taxation of U.S. profits. At the same time, API hopes that the Committee will remain aware of the adverse, retaliation provoking effect of deviations from international standards for 1) arrogating taxing jurisdiction, and 2) employing compliance features. API member companies (and ultimately its U.S. shareholders), with major operations in many foreign taxing jurisdictions, would be among the victims of such retaliatory actions by foreign governments. Aside from this exposure to retaliation, the Bill's proposal to extend the U.S. taxing jurisdiction and expand compliance burdens on foreign owned enterprises appear anachronistic in this era of continuing world trade integration.

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STATEMENT OF PROFESSOR STANLEY I. LANGBEIN
TO THE OVERSIGHT SUBCOMMITTEE
HOUSE WAYS AND MEANS COMMITTEE
SUBMITTED AUGUST 1, 1990

My name is Stanley I. Langbein. I am an Associate Professor of Law at the University of Miami Law School. During the last 5 years, I have published two articles on transfer pricing, the first in February 1986, and the other in September 1989. I work from time to time as a consultant to a law firm which represents foreign-owned firms in transfer pricing matters. This statement is submitted entirely on my own behalf. I do not represent any other party in making the following submission.

My published work is identified with the position that the arm's length standard does not work and cannot be made to work. When I first took this position, in 1986, it was a highly unorthodox view, but in the years since, many more people have come to share it.

In this statement, I would like to set forth the basic reason why I believe the arm's length method does not work and will never work. I wish to do this not so much because I believe it is either the Subcommittee's intention or its mission to inquire, at this juncture, into the general question whether the arm's length standard is "working." Rather, I wish to go into the matter because the specifics of the criticism of arm's length explain two things which appear to be central concerns of the Congress at this moment, but which the Subcommittee may misapprehend.

The first point concerns the question of tax compliance by foreign-owned companies. There are allegations now appearing in the media throughout the United States that some U.S. subsidiaries of foreign companies "cheat" on their U.S. taxes. It was suggested during the hearings that it may be appropriate to consider criminal proceedings against some of these companies. But if one understands the fundamental conceptual flaws of the arm's length system, one can understand why such companies can pay very little in U.S. taxes, and still not be "cheating" at all. Thus, the first point is that **THE PUBLISHED FACTS DO NOT MEAN THAT FOREIGN-OWNED COMPANIES ARE CHEATING ON THEIR TAXES.** The problem resides in the law, not in the behavior of the companies. Suggesting otherwise is misleading and counterproductive to the genuine -- and very important -- tax policy issues which are presented.

The second point concerns revenue estimates. The Subcommittee was visibly but understandably frustrated at the hearings by the Government witnesses' refusal to give estimates of the revenues involved in these audits. Revenue estimation is difficult in this area because it depends to some extent upon "home country" data not freely available to the Government. But there is a deeper problem with revenue estimation, which is revealed by an understanding of the conceptual problem with the arm's length method.

The central critique of arm's length is that, in many transfer pricing cases, a large amount of taxable income is left indeterminately allocated among the competing jurisdictions, and is left to be divided according to ad hoc, subjective determinations by the administrative officials or the courts. In any transfer pricing case, when one refers to the amount "at stake," one may mean either of two things. On may mean the total which is indeterminately allocated by the arm's length standard, on the one hand, or, on the other, the amount which finally will be allocated to United States tax jurisdiction, the amount the United States has a valid claim to tax.

It is true that a large amount of revenue is involved. But the total amount "at issue" in the cases -- measured as the difference between the companies' opening position and the IRS' opening position -- is not really what is relevant, because everyone concedes from the outset that some of that money "belongs" to the foreign government. What is really at issue is the amount "at stake" in the second sense I indicated -- the amount which the United States "should" end up with -- the amount the United States has a valid claim to tax. But the real difficulty is that that number is indeterminable -- because the law is lacking in concrete and intelligible norms concerning the extent of a "host" country's right to tax.

This is an insight with which I would expect the Subcommittee to be decidedly uncomfortable. Billions of dollars in tax revenue may or may not be available to the United States. Under current law, "how much" the United States may validly claim is not the subject of concrete, intelligible norms and rules. It depends, rather, upon the outcome of ordinarily secret and highly subjective negotiations between the taxpayer and the IRS, or between the IRS and a foreign government, or of equally subjective judicial decisions which provide no useful precedent for future cases or guidance as to what the law "is." This is an inappropriate way to manage public financial affairs, needless to say.

I will begin with a brief description of the theoretical attack on arm's length (part 1) and of how that analysis explains many of the anomalous circumstances the Subcommittee's inquiry has identified (part 2). I then make my two basic points: that the low income reported by foreign companies is not the product of cheating (part 3); and that the indefiniteness of arm's length undermines the budget process (part 4). I conclude with some observations on the most appropriate directions for congressional action and policy at the present time.

1. The problem with arm's length

The starting point is a brief description of what is wrong with "arm's length."

If one understands not only that arm's length is a problem, but also why, one can understand that what is happening is not "tax cheating" at all, but a logical outgrowth of an illogical system.

The Joint Committee's pamphlet suggests that the arm's length standard does not work because it presupposes integrated companies treat each other "as if" they were independent, whereas in reality integrated companies do not behave this way. Integrated companies exist because of "integration economies" or "synergies" which business integration exploits.

The arm's length standard fails because it creates a continuum price problem. The continuum price problem arises as follows. Under arm's length, you first look for comparable uncontrolled prices. Since you are examining an industry and production situation which has called forth integrated multinational companies, the theory of the firm tells you that you probably will not find comparable uncontrolled prices. In practice, it turns out that comparables are rarely found.

Next, arm's length tells you to do the "resale price" determination or the "cost plus" determination. In substance, these methods tell you to look at one or the other "related" parties, and to ask, if that party were unrelated, what price would it take to induce it to enter this transaction?

The trouble is, the price you determine depends upon which component you examine. If you look at the reselling/distributing arm, you find that a price which is relatively high in relation to the ultimate selling price is the maximum selling price which would induce a party to enter the transaction. On the other hand, if you look at the producer/first seller, you find that a price which is relatively low in relation to the ultimate selling price is the minimum selling price which would induce a party to enter the transaction. Any price which is equal to or higher than the producer's minimum price, but also lower than or equal to the reseller's maximum price, would induce both parties to enter the transaction. Therefore, any such price is an arm's length price. The arm's length method is thus indeterminate; it generates not one price, but a continuum of prices.

An example will help. Suppose automobiles are at issue, the production cost of which is 35x, and the distribution cost of which is 10x. Suppose the ultimate selling price is 100x, so that the sale generates overall profit of 55x.

We can show, however, that the distributor, whose cost is 10x, will be satisfied with a profit of 5x, so its maximum buying price will be 85x (which will leave it to generate 15x gross profit, and 5x net of its distribution cost, when it sells for 100x). Suppose, however, the producer (whose cost is 35x) would be willing to settle, at the margin, for profit of 10x. Its minimum selling price is 45x. Any price between 45x and 85x is an arm's length price -- since both the producer and reseller would be willing to deal at any of those prices. But you have no basis for selecting a price along the continuum. Moreover, you started with profit to allocate of 55x. You have allocated 15x determinately (5x to the distributor, 10x to the manufacturer), but the arm's length idea doesn't help you with the other 40x -- the lion's share of the profit. The taxpayer doesn't know what price will be deemed an arm's length price and neither do the IRS or the courts. And neither does the home country government.

2. The explanation of many mysteries

This concise explanation of the problem explains a number of apparent anomalies which have attracted the Subcommittee's attention, but which, absent an understanding of the real underlying issues, can be cast in dangerously misleading lights. Among the things explained:

1. The companies are not necessarily doing anything wrong -- and certainly nothing that approaches fraud. Suppose, in our example, the producer/original seller is the foreign (home country) component of the multinational, and the reseller/distributor is the domestic U.S. subsidiary. Suppose, further, that the effective tax rate is lower at home than in the United States, which may occur because the statutory rate is lower; because the home country provides more generous depreciation or other allowances; or because the production actually takes place not in the home country but in developing "tax holiday" jurisdictions with which the home country has "tax sparing" conventions; or for some other reason. What transfer price would you expect the company to set? 85x. That minimizes United States tax in

relation to the income ultimately earned by the multinational group. But it is "an" arm's length price, according to the definition. So it is OK. It is true that it is so extreme that it looks fraudulent. But it is OK, because the law is very irrational. On the other hand, the home country taxing authority may concede 85x is also extreme, but is strongly in that country's own fiscal interest. That's OK too.

2. By the same token, the IRS' positions are not "extreme," even though they are drastically different from the taxpayers'. Again assume the numbers of our example, that our producer is foreign, and that it prefers paying foreign tax to U.S. tax, and so sets a transfer price of 85x. What do you expect the IRS to do? Of course: take the position at the opposite pole, say the price is 45x. This is OK, too. It looks like a police state tactic, much as the taxpayer's move looks fraudulent. But it is OK. It is not even fair to call either party's action "gaming" the system. The parties are doing what the system compels.

3. There will always be billions in dispute. In fact, the numbers given in our example are not atypical of the transfer pricing cases. There almost always is a large excess of revenue over the sum of the amounts which give a "marginal" return to all of the components. The spread between the two, in fact, is frequently as much as half the total revenue. One has to go a bit more deeply than I have into the theory of the multinational corporation to fully understand why this is true. Most economic situations occasioning significant "multinationality" will involve large-market, high-profit, information-intensive industries and transactions, with significant income-producing intangibles present. So there will be a large margin of revenues over costs, typically, and a large "residual" after allocating "marginal" returns to components. This "residual" will not be determinately allocated by the arm's length method. So in the aggregate there will always literally be billions "up for grabs."

4. It is possible for a component of a multinational to show a negative cash flow, or a negative return on equity, forever. Several witness at the hearings, sometimes at the suggestion of members of the Subcommittee, said that it was "inconceivable" that a business would maintain an investment which over an extended period of time showed an excess of costs over revenues, or a negative return on equity. It is not only conceivable, but it is typical of many operations in integrated multinationals -- and tax evasion or tax fraud are not involved at all.

This can be explained by an example. I will use Holiday Inns, because it is referenced in some of the multinational corporation literature. I stress I am not talking about any particular taxpayer's tax situation, or even its real business situation; I am just using a familiar name to make the argument understandable. Suppose Holiday Inns is considering building a chain of hotels in Spain. Spain is a rough location for the hotel business (we assume) -- costs are high, rates low. So Holiday Inns knows its contemplated operations will generate an excess of cost over revenue, forever or at least for the foreseeable future.

It may still enter Spain. This is because the heart of the profit of the entire chain is the existence of an international network of travelers who like and when possible stay in Holiday Inns (and a larger network who sometimes stay there and generally trust the name). If Holiday Inns is not in Spain, these travelers' allegiance will weaken, because their trust in the company will be less or because they will find other chains which they might come to like better. So Holiday Inns makes the investment.

Moreover, it will be more rather than less likely to make this investment through a related company, rather than a licensee, on account of the low profitability of the enterprise. This is because it will be suspicious that a licensee will "free ride," reducing costs by impairing service, which will do even more damage to the company's international standing than not investing would. That risk obtains generally, but intensifies where operating profit is marginal. And this decision is independent of and not driven by tax considerations -- the Spanish investment could be made exactly as hypothesized in a world without any taxes at all.

This example suggests that a permanent low or negative profit picture in an outlet of a multinational is not only conceivable, it may be typical. Apparent low profit may be symptomatic of the circumstances which led the company to become integrated in the first place. The low profit is only apparent, of course; the key is to bear in mind the revenue outside Spain "protected" by the Spanish investment.

This example also suggests why multinational audits tend to turn up a "residual" -- a supernormal excess of revenue over costs. Multinationals are integrated because they are protecting advantageous and valuable, and easily destroyed, "specific assets," frequently in the nature of intangibles -- Holiday Inns' international reputation and standing with a network of travelers, in the example. Where there are no such "specific assets," companies are free to trade through unrelated distributors, and, because of the costs of "multinationalizing," they usually do. Exemplary is the steel industry. Steel involves neither specialized technology nor reliance on brand names or consumer goodwill. Japan exports large quantities of steel to the United States, usually through unrelated distributors.

Understanding the continuum price problem explains many things which otherwise appear in a different light. One may see in underreporting of income fraud or misconduct on the part of companies, or obstruction and uncooperativeness, or "gaming" the system. But the continuum price problem reveals that the companies are doing only what they must under a bad law. One may see in the IRS' large proposed adjustments abuse of power, or in its failure to sustain the adjustments evidence of understaffing or disorganization. But the IRS is only doing what is must, and is overwhelmed by an enforcement burden which, given the nature of the law, is impossible to discharge.

Let me draw out my two points: that accusing foreign companies of misconduct is incorrect, unfair and not useful; and that it is impossible to talk meaningfully about the amount of revenue loss at this juncture.

3. No tax cheating

First, an appreciation of the continuum price problem, of itself, suggests why there can be what appears to be "billions" in "underpayments," but at the same time no fraud. There simply are a wide range of defensible prices, and one cannot penalize or convict a taxpayer for choosing a price at whichever of the extremes suits the taxpayer, for that is perfectly lawful.

The Subcommittee asked at the hearings whether one could use different prices in reporting to different countries. To return to our example, our foreign manufacturer would make its transfer price 85x if it wished to "avoid" U.S. tax; or it might wish to "avoid" its home country's tax, and then it would set a transfer price of 45x. But what of the device of reporting different prices to different countries -- use 45x in reporting at home, and 85x in reporting to the United States. This has huge tax savings potential. Is it lawful?

This differential reporting probably is not lawful; in any event, I really do not think substantial multinational companies do this. As a legal matter, under U.S. law, you must report the income on the basis of the transfer price you "actually" charge.

That is, although the rules give you great latitude in selecting a transfer price, you must actually select. Now, it is conceivable that some foreign country's law would permit you to report a price defensible as an "arm's length" price but different from the price you actually charge. You then might "book" or "invoice" goods at the price you wanted to use for U.S. purposes, while using the lower price, permissible under the foreign law, for foreign tax purposes.

I cannot say for certain that this is illegal under United States law -- the question what one's "actual" transfer price is bears enough ambiguity that I might not, say, as a judge or member of a professional review board, sentence a corporate official or disqualify an attorney or accountant who tried it. But every lawyer I have ever talked to about this has said that he or she would not countenance this, and that the foreign multinationals are not doing this. The larger multinationals, at least, have professional and technical staffs, who know (and care) that 2 plus 2 is 4. Thus, they are reporting the income somewhere.

Second, concerning criminal penalties, one must understand that the Regulations, as currently drafted, do not purport to set forth standards binding on taxpayers, but only audit guides to the Service. That is, the Regulations do not in terms say that a taxpayer must use a transfer price conforming to the guidelines set forth in the Regulations, and they are quite explicit in denying taxpayers the right to "affirmatively" use the Regulations to defend their prices. Instead, the substantive guidelines are only for the Service's use in making readjustments and reallocations with respect to prices initially set by the taxpayer.

The White Paper would change this, by requiring a taxpayer to supply a defense of transfer prices with its return. The White Paper, and at least one of the witnesses at the hearings, suggested that this change could be made by administrative action and would not require legislation. I am much less sanguine that this is so. The current statute is only an authorization to the Service to make readjustments and reallocations; I do not see where it authorizes the Service to impose a particular method of reporting on taxpayers. In any event, for past years, and until such a change were made, it is difficult to see how one can bring criminal charges against someone for having failed to comply with guidelines with which the law did not clearly say you had to comply, particularly in the case of "guidelines" which are indeterminate and vague in practical effect. Certainly, many if not most practitioners in the criminal tax defense bar believe the Government cannot bring or sustain criminal tax properties for failing to comply with the 482 Regulations.

Finally, and this may be most important, the central task is fixing a system now in bad disrepair, that is, changing the substantive rules. Other countries are committed to the existing system, with a degree of determination I would caution the Subcommittee against underestimating. Opprobrious charges, intimations of criminality, breaches of the confidentiality of the tax examination process can only sour the atmosphere, and make the task of securing agreement in a highly sensitive, poorly understood area more complicated. This is particularly so because the Congress may encounter occasions, in the process of working out the transfer pricing problem, when it will genuinely pay to be "tough." Phony charges of misconduct, in this context, represent phony toughness.

There is a danger, in addressing this serious situation, of going off in the wrong direction. **And characterizing the situation as a product of cheating or misconduct is the wrong direction, because the problem is the tax law, not the taxpayers.**

4. The revenue estimate problem

The second consequence of confusing a problem of substantive law for a problem of compliance concerns the amount of revenue at issue. One must begin by realizing that there are two different aggregate amounts one has to think about.

Recall in the example above the total profit was 55x, of which we said 10x "definitely" belonged to the producer country (let us assume it is Japan), and 5x to the consumer (host) country (which we can assume is the United States). Thus, 40x of profit is "indeterminately" allocated. If the effective United States tax rate is 34%, then 13.60x is "at issue" under arm's length. This is the first amount one has to think about.

But let us say that the effective Japanese rate is 14%. This rate may arise because of Japanese tax law, or because Japan has "tax sparing" conventions with places like Singapore, which the company takes advantage of. Because of the lower rate, the company sets 85x as its transfer price. Thus it "pays" 5.60x in Japanese tax; and its savings from its "manipulation" of the transfer price is 8.00x, not the whole 13.60x.

There is a further consideration, however, in that you concede at the outset that some of the tax revenue on the 40x in profit rightly belongs to Japan. But -- and this is a critical point about revenue -- you simply do not know how much, because there is no single, determinate arm's length price, and thus no knowable allocation of the tax base between the two countries. It is all left up to ad hoc subjective determinations.

In our example, suppose we just, out of thin air, assume the "proper" transfer price is 65x, which splits the tax base 50-50. I stress this is an assumption only of convenience, with no normative basis in fact, law, or economic logic. Then the taxpayer would pay 2.80x to Japan; 6.80x to the United States, a total of 9.60x. Our original 13.60x is split into three components: half of it (6.80x) is U.S. tax; 2.80x is Japanese tax; and 4.00x is a "legitimate" (that is, intended by a rational tax law) tax saving to the taxpayer. This 6.80x which we ultimately get is our "true" revenue claim, and it is the second amount one has to think about. Moreover, of the 6.80x we would "lose" on account of the "inflated" transfer price, 2.80x under the inflated price goes to the Japanese Treasury, and 4.00x to the taxpayer.

There are, accordingly, two very different concepts of lost revenue. One results from multiplying the tax rate by the total amount which is indeterminately allocated under arm's length. This is the 13.60x figure in the example. This is the amount which tends to be nominally at issue in the cases. I say nominally because it is recognized from the outset that some portion of the revenue does not on any theory belong to the United States. This amount is undoubtedly in the tens of billions in the aggregate, because, as I say, the lion's share of profits in high profit industries is indeterminately allocated under arm's length. But it is not a true "revenue loss" concept.

The second figure is the 6.80x in our example, which is legitimately "lost" to our Treasury on account of the taxpayer's pricing practices. This figure will be substantially less than the total revenue which can and will be put "in issue" in the transfer pricing audits. It is still large, but considerably smaller than the first.

Now, it may and should be of concern to the Congress that revenue amounts of this magnitude are left "up in the air," "up for grabs" by ad hoc determinations by the administrators, who make nonpublic compromises among themselves in settling audits, in appeals, in the competent authority process, or by the courts, which determine matters on a case by case basis, not according to any coherent or consistent doctrinal principles. But that is in fact what happens under current law.

The distinction between the amounts which can be put "in issue" and those we can legitimately claim puts some of the Subcommittee's concerns in a different perspective. Figures like $30 billion and $50 billion were being mentioned at the hearings. Those figures are not large as estimates of the magnitude of the income which may be put "in issue" under "arm's length." But they are too large as estimates of the total we can legitimately claim. Nor can one assume that the proper figure is determined by "halving" the aggregate estimate -- the 50-50 split in the example was based on a totally arbitrary assumption. As I stress, the amount "really" at issue is indeterminable.

Also, understanding this distinction gives one a different perspective on the administrative performance. One of the members was concerned the IRS is settling cases for about 26%. That seems low, but, especially for "inbound" cases, that is not bad, considering that a large part of what is claimed in the cases legitimately belongs to the other country. The real administrative problem is not in the cases that are settled, but in those that are not and cannot be brought because resources are limited. There the taxpayers simply get away with the selection of a tax regime for a large portion, or the preponderance, of their income. Again, the problem is not one of administrative performance, but of administrative burden. The irrationality of existing rules creates a burden that cannot and will not be borne, no matter what the Congress or the IRS do.

The distinction concerning revenue aggregates also has to be borne in mind in assessing the macroscopic aspects of the problem. Although there is no way to be sure, it is probably the case that most of the "lost" revenue goes not to the taxpayers, but to the foreign fiscs. This means that the competitive implications of the matter for U.S. business may not be as serious as may appear at first blush, although I do not wish to minimize this problem. If the question of billions in tax payments were a question of "whether," the situation would represent gross favoritism toward foreign investment. But if it is only a question of "which" of two relatively high rates is to be applied, the impact on competition is not nearly so great. In fact, the statutory corporate tax rates are considerably higher in Japan than in the U.S. It is not tax cheating -- or tax savings in any form -- which is fueling Japanese business success.

Finally, and here if I am repeating myself, it is only because the point is of apparent currrent concern to the Congress, the most important thing to recognize is that, notwithstanding the eye-catching magnitude of the tax base at stake, you cannot make a revenue estimate because there is no stable extant norm for allocating the tax base. The Treasury and IRS would deny this. They would say arm's length gives you definite results. But if you look at almost any given case, you will realize this is not true. Almost any given case will assume a picture like the one I have sketched of the typical case, and a large portion of the tax base will be left without definite allocation, and without any guide as to how to tax it.

5. The proper course of action

Obviously, if my diagnosis is correct, the pressing need is to develop, as expeditiously as possible, a rational system of allocation. This, however, is an international problem, and requires a multilateral solution, or at a minimum a series of bilateral solutions. Such a solution cannot be achieved by unilateral action, and in my judgment, unilateral action at this point -- in the form of, say, a mandatory 50-50 profit split in transfer pricing or the like, or a "minimum tax" based on gross receipts -- will not be helpful. Irrational as the "arm's length" standard is, foreign authorities and foreign business are fiercely dedicated to it. Moreover, neither the Treasury nor the Congress appears to have yet decided that the standard is the real problem and needs to be replaced. Such a decision is, however, inevitable before any real progress in international taxation can be made.

In the meantime, the rhetoric surrounding this issue is promising to create first order difficulties. I realize that the points made here are, to some extent, legalisms which will not make too deep an impression on the general public. Lawyers understand the distinction between tax evasion, on the one hand, and tax minimization under a defective law on the other; and lawyers understand the need to secure international agreement, even where the matter may be one where the existing international regime is not entirely "fair." But the taxpaying public is not likely to be pleased, particularly at a time when its taxes are being raised, by being told that multinational corporations are obviously and concededly undertaxed under a system that is not working, but that it will take time and a long drawn out process before this is corrected, with billions lost in the interim.

As to the course the Congress should pursue, it should be clear I think the first step is to get some agreement on fundamentals. At the hearings, the Chairman examined the idea of appointing a "blue ribbon commission" on this matter. This may be useful, but one should define what it is any such commission is to do. What is needed is a definition of what we want in terms of a substantive allocation system -- a "United States position" on the question of substantive allocation. Arm's length is not the answer, it is a "no man's land," and a proper inquiry will make that clear. The foremost question is what is our revenue base. The total "asserted" amount in the transfer pricing is "obviously" not all "ours." The question is, just what portion of that revenue is it that we want to claim? We are going nowhere until we ask and begin to answer that question.

Once you do decide on your objective, you still have the problem of negotiating changes in existing conventions and international arrangements, of seeing what the treaty partners will accept or demand in exchange. But you cannot tackle that more difficult undertaking until we have our house in order as to what our substantive position is.

So a blue ribbon commission might be useful in developing such a substantive position -- although it will still leave you a long way from a solution which can be implemented, because that requires international cooperation. Measures short of appointing a commission might help, too. Hearings before other subcommittees of the Committee, such as Select Revenue Measures, or before the full Committee, might inquire into the quite difficult substantive economic issues involved, in an effort to develop a "negotiating position."

Along these lines, I also think it worth pointing out that at the hearings, and nowhere more than in Representative Gephardt's testimony, I heard the sounds of what really is, and ought to be recognized as, a very new bell. I was not the only person in the room who heard those sounds. Conventionally the "fundamental" issue in this area is thought of as arm's length vs. fractional apportionment or the unitary method. But what some members of Congress are saying raises issues beyond this 50-year-old debate. The argument in Congress is that foreign investors should be placed on the same footing as domestic investors -- if you deal with American consumers, you play by American rules, in the Majority Leader's words. That really is new. "Arm's length" and "unitary" tax both, in both theory and practice, "tilt" the allocation toward the "home" country -- arm's length probably more so than unitary, but both assume that what is being equalized is the treatment from the standpoint of a given investor of domestic or foreign investment (capital export neutrality). The suggestion in the current debate is that what should be equalized is the treatment of a given investment, whether made by a foreign or domestic investor (capital import neutrality).

This is new. It is also, in my opinion, worth further scrutiny. The modern theory of the multinational corporation will tell you that to equalize the treatment you not only need some "global" method, but one which allocates a good deal more to the "host," rather than the "home," country than either the historic unitary or the arm's length methods achieve.

Return to the Holiday Inns example. Holiday Inns will be competing, presumably, with local investors who must, somehow, cover costs. If they do, they will be taxed in Spain. If the idea is that the Spanish tax system should impinge on the mind of Holiday Inns management in the same way it impinges on the mind of the Spanish entrepreneur, then one must find a way to bring some part of the revenue outside Spain which is "protected" by the Spanish investment into the Spanish income tax net. That is not easy to do, but if the idea is equality of treatment between the multinational and the local competitor, one has to find a way to do it.

But one must also realize that it is really very much a departure from established practice and policy. So getting it accepted, even in a partial degree, will take time, patience, and effort, and may ultimately be achievable only in partial degree.

In the present circumstances, I believe it would be best for everybody, especially the Government but for Congress as well, to tone down the rhetoric. For if the impression is created that all the revenue at issue belongs to us; that the question is whether, rather than to whom, it is taxed; and that the failure to tax it is attributable to outrageous conduct on the part of foreigners, an unfortunate course of events may become inevitable. Congress will be called upon to go beyond stepped up compliance, and to enact unilateral measures which challenge, or which openly defy, provisions of bilateral conventions in force. The idea will be to compel action or agreement by our trading partners. But the result is apt to be the opposite, to stiffen the trading partners in resisting our position, because we will simply look silly, or worse.

In short, I believe the existing allocation system is unsound, and there are some compliance problems, and the Subcommittee is to be congratulated for having raised serious issues. But the instant public rhetoric threatens two serious difficulties. It may lead to unfair, opprobrious charges being brought against businesses which or individuals who are operating fully within the law. And it may generate irresistible pressure for premature congressional action which in turn will be disruptive of achieving an ultimate solution of the problem.

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August 30, 1990

The Honorable Robert J. Leonard
Chief Counsel
House Ways & Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Re: Comments on the Foreign Tax Equity Act of 1990, H.R. 4308 and S. 2410

Dear Mr. Leonard:

In my letter of August 16, 1990, to Congressman Pickle regarding the Oversight Subcommittee Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Companies I mentioned that our comments on the Foreign Tax Equity Act would be forthcoming. I herewith enclose such comments. They were prepared by members of our Committee on U.S. Activities of Foreigners and Tax Treaties and reviewed by members of our Committee on Government Submissions.

The comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Jere McGaffey

Jere D. McGaffey
Chair, Section of Taxation

Enclosure

cc: Janice Mays, Chief Tax Counsel

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON THE FOREIGN TAX EQUITY ACT OF 1990, H.R. 4308 AND S. 2410

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by a Task Force of the Committee on U.S. Activities of Foreigners and Tax Treaties. Members of the Committee who submitted comments were (in alphabetical order) Alan I. Appel, Nicholas S. Freud (Committee Chair), Dean C. Gordanier Jr., Michael J.A. Karlin, Barry J. London, David L. Raish (Committee Vice Chair), Richard Schaul-Yoder, Leonard Schneidman (Task Force Chair), and Thomas S. Wisialowski. Comments also were received from Michael Hirschfeld and Nina Krauthamer of the Committee on Real Property Tax Problems. Questions may be directed to Leonard Schneidman (617-482-1390) or Nicholas S. Freud (415-442-1100). These comments have been reviewed by David Foster on behalf of the Committee on Government Submissions and by Richard M. Lipton. Mr. Gordanier has a specific client interest in this matter.

Dated: August 24, 1990.

We are writing to offer our comments on the proposed Foreign Tax Equity Act of 1990 (the "Bill"), which Mr. Rostenkowski introduced as H.R. 4308 on March 20, 1990, and which Mr. Levin introduced in identical form as S. 2410 on April 3, 1990. Title I of the Bill contains three provisions. The first provision (section 101 of the Bill) would apply the 1989 amendments to the information reporting and related provisions of section 6038A of the Internal Revenue Code (the "Code") to open tax years. The second provision (section 102 of the Bill) would add section 6038C to the Code, subjecting all foreign corporations that carry on trades or businesses in the United States to information reporting and record maintenance rules similar to the present-law rules of section 6038A for certain 25-percent foreign-owned corporations. The third provision (section 103 of the Bill) would add a new paragraph (9) to section 6501(c) of the Code, permitting the Internal Revenue Service to extend the statutory period for the assessment of "foreign related deficiencies."

Title II of the Bill re-proposes sections 899 and 1447 of the Code, which were considered and rejected as section 11404 of the Revenue Reconciliation Act of 1989 (the "1989 Act") (Title XI). A Task Force of our Committee, composed of many of the same members as the current Task Force, submitted comments on the 1989 Act's versions of these proposals.[1] The Bill's versions of proposed sections 899 and 1447 are substantially the same as those included in the House version of the 1989 Act. As in the 1989 legislation, proposed section 899 would tax non-resident alien individuals and foreign corporations when they sell stock of any U.S. corporation in which they hold more than a 10-percent stake; proposed section 1447 would require withholding agents to collect the tax. The drafters of proposed sections 899 and 1447 have modified the proposals in certain respects.

With regard to Title I of the Bill, we support its intent of increased compliance by all persons (including foreigners) doing business in the United States. Nonetheless, we are concerned that unilaterally adopting these statutory audit procedures and sanctions may damage the United States' ability to obtain necessary cooperation in international tax relations, because foreign tax authorities view the measures as discriminatory, extraterritorial and unnecessary. In addition, the proposals will increase the already significant and costly burdens imposed by section 6038A. These new rules are particularly troubling when applied to our treaty partners with whom we have entered into nondiscrimination agreements. Accordingly, we recommend that Congress should clarify that the provisions of Title I shall not apply to the extent they may override treaty non-discrimination clauses, and should make several revisions to the provisions of Title I in order to increase the likelihood of compliance. In addition, we believe that section 103 of the Bill, which extends the statute of limitations for foreign-owned corporations, is inappropriate and should be deleted.

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[1] James P. Holden, Chair of the American Bar Association's Section of Taxation, delivered these comments to Ronald Pearlman, Chief of Staff of the Joint Committee on Taxation, under a cover letter dated October 18, 1989. A copy of those comments is attached to this submission.

With regard to Title II, we are gratified that Congress has removed the unilateral express treaty override and has improved the "investment partnership" rule contained in the 1989 proposal. Nonetheless, Title II in its present form continues to raise the same concerns as did the 1989 proposal with regard to its broad and far-reaching effects on international tax policy, the economy and U.S. tax laws. Our prior submission discusses these concerns in detail, and, except as pointed out below, we continue to adhere to the comments and conclusions set forth in our prior submission.

In addition to the concerns described in our prior submission, we have the following concerns about some of the differences between sections 899 and 1447 as reproposed in Title II of the Bill and those sections as proposed for inclusion in the 1989 Act. First, we recommend that if Title II is enacted, the limited statutory overrides of treaties for non-qualified residents and for future treaties should not be included in any final bill. Second, we recommend that subsection (e) of proposed section 899 be dropped. Third, if Title II is enacted, we remain concerned that although the investment partnership exception has been improved, the venture capital exception, which was dropped, continues to be needed. Finally, we point out the arbitrary nature of the "zero-basis" penalty of proposed section 1447 and the need for coordination of section 1447 with existing withholding regimes, possibly by way of revising existing section 1445 to encompass the withholding provisions of proposed section 1447.

Because of the concerns described below and in our prior submission, we continue to believe that Congress should not enact Title II of the Bill. The balance of this submission presents our comments on the Bill in detail.

I. TITLE I.

A. Description of the Provisions.

Section 101. Section 101 of the Bill would apply the 1989 amendments to the information reporting and related provisions of section 6038A to open tax years.

Section 102. Section 102 of the Bill would add section 6038C to the Code, subjecting all foreign corporations that carry on U.S. trades or businesses to information-reporting and record-maintenance rules similar to the present-law rules of section 6038A. The provision achieves this result by removing the 25-percent foreign-ownership threshold required under current law to trigger foreign corporation reporting. In addition, section 6038C would require the corporation to maintain records and file reports with respect to "other information" to be specified in regulations.

Section 103. Section 103 of the Bill would add a new paragraph (9) to Code section 6501(c), permitting the IRS to extend the assessment period up to an additional three years for any transaction between a domestic corporation that has at least one 25-percent foreign shareholder and a related foreign person, and for any deficiency related to effectively-connected U.S. trade or business income, the branch profits tax or the branch-level interest tax imposed on a foreign corporation, if the taxpayer's actions have prevented a timely assessment of the deficiency.

B. Comments and Recommendations.

Viewed in a narrow procedural context, the proposed changes in Title I (other than section 103) do not represent a significant departure from the scope of existing statutory mechanisms that Congress has established to aid the IRS in enforcing the U.S. tax laws. Nevertheless, unilaterally adopting these statutory audit procedures and sanctions may damage the United States' ability to obtain necessary cooperation in international tax relations, because foreign tax authorities view the proposals as discriminatory, extraterritorial and unnecessary. In addition, the already significant and costly burdens imposed by section 6038A and the 1989 amendments to that section will be increased by these proposals.

In order to preserve cooperation in international tax matters, Congress should clarify that the provisions of Title I shall not apply to the extent that they may override treaty non-discrimination clauses. In order to increase the likelihood of compliance, we recommend first that the March 20, 1990, cut-off date for discarding documents be changed to a date at least six months after the later of the date of enactment or the date on which regulations under section 6038A are promulgated. Second, records and reports regarding "other information" should be required under section 6038C only with respect to periods after the date on which regulations are promulgated specifying the "other information" to be furnished. Finally, we believe that section 103 of the Bill should be deleted. A longer statute of limitations on foreign-owned corporations than relates to U.S.-owned businesses not only violates the non-discrimination clause of most tax treaties, it is also an invitation to retaliation.

1. International Tax Relations.

The enactment of Title I is likely to impair Treasury's ability to negotiate tax treaties and to damage the relatively cooperative nature of international relations with regard to tax matters. Foreign tax authorities' reactions to Title I indicate that our treaty partners view these proposals as discriminatory in practice, because the proposals adopt audit standards for foreign corporations and foreign-owned United States corporations that are materially more burdensome than the audit standards generally applicable to United States corporations.[2] In addition, our treaty partners view the Title I proposals as extra-territorial. Finally, they regard the proposed changes as unnecessary, asserting that tax treaties contain exchange-of-information clauses more than adequate for the United States to obtain the documentation it needs to enforce its own tax laws.

We support the ultimate goal of Title I of the Bill--increased compliance by all taxpayers. This goal does not justify, however, disregarding our treaty commitments and the expectations of our treaty partners. In fact, the proposed audit standards may violate the non-discrimination provisions of tax treaties if the regulations promulgated under section 6038A subject foreign corporations and foreign-owned U.S. corporations to information maintenance and reporting requirements more onerous than those applicable under section 482 to U.S. corporations that operate overseas.[3]

As we stated in our prior submission on proposed sections 899 and 1447, the United States needs the cooperation of other countries with respect to important international tax matters, such as negotiating treaties, requesting information and obtaining help in enforcing U.S. tax laws, and resolving double-taxation cases. We anticipate that unilaterally adopting these statutory audit procedures and sanctions will reduce the likelihood that such cooperation will be forthcoming. Accordingly, in order to preserve necessary cooperation in these matters, we recommend that Congress clarify that the provisions of Title I shall not apply to the extent that they may override treaty non-discrimination clauses.

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[2] See, e.g., "Rostenkowski and Gephardt Introduce Bill to Squeeze More Taxes from Foreign Firms," 46 Tax Notes 1485 (March 26, 1990); Letters from British Ambassador Sir Anthony Acland to Rep. Rostenkowski (May 3, 1990) and Senator Bentsen (May 2, 1990).

[3] No such non-discrimination argument can be advanced with respect to section 103 of the Bill; section 103 violates the non-discrimination clauses of most treaties because it allows extension of the statutory assessment period only for foreign-owned domestic corporations and foreign corporations, and not for U.S.-owned domestic corporations.

2. Compliance Burdens.

Until the IRS promulgates regulations under section 6038A and the 1989 amendments to that section, it is difficult to quantify the burdens involved in complying with the requirements of that section. Nonetheless, it is clear that those compliance burdens will be significant and costly. Those burdens will be increased by sections 101 and 102 of the Bill. In particular, the Bill would impose sanctions for failure to preserve records for open years, even though the taxpayer could not have known during those years that the law would be changed in the future to require retention of such records. The House Ways and Means Committee's "Technical Description of the Bill" (the "Technical Description") attempts to provide relief by stating that the sanctions would not apply if the records no longer exist, provided the taxpayer can show that the records were discarded in the ordinary course of business prior to March 20, 1990. It is not clear, however, that this statement will provide relief in actual practice to a corporation that cannot produce such records. First, the corporation will bear the burden of proof: it must show not only that it discarded the pre-March 20, 1990 records both before (and not after) this date, but also that it did so in the ordinary course of business. Second, many foreign corporations certainly are still not aware of these proposals, and still are routinely destroying documents in the ordinary course of business. Third, at least until regulations are promulgated under section 6038A, the taxpayer cannot know which documents existing on March 20, 1990 it must retain. Accordingly, the taxpayer apparently cannot discard any documents existing on such date until regulations are promulgated defining the limits of the statutory record-maintenance and information-reporting requirements. In order to ensure that taxpayers will be aware of the requirements to retain documents and also that they will retain the proper documents, we recommend that the March 20, 1990, cut-off date be changed to a date at least six months after the later of the date of enactment or the date on which the IRS promulgates regulations under section 6038A.

These compliance concerns are exacerbated under proposed section 6038C, because of that section's requirement that the taxpayer maintain records and file reports with respect to "other information" to be specified in regulations. In order to permit corporations to adjust their record-keeping practices to accommodate any regulatory requirement to furnish "other information," the Bill should clarify that records and reports regarding "other information" will be required only with respect to periods after the date on which regulations are promulgated specifying the "other information" to be furnished.

Finally, we believe that section 103 of the Bill is inappropriate. A different statute of limitations for foreign-owned corporations and foreign corporations is directly contrary to the nondiscrimination provisions in most of our tax treaties. Moreover, a longer statute of limitation for foreign-owned corporations and foreign corporations is an invitation to retaliation. If Congress believes that the current statute of limitations is inappropriate, a new one should be enacted for all taxpayers; foreigners should not be singled out for special treatment. We join Treasury in opposing the enactment of section 103 of the Bill.

II. TITLE II.

We understand that the 1989 proposal to enact sections 899 and 1447 was neither intended nor expected to raise significant revenues. Rather, the proposal was intended to remove a perceived advantage of a foreign direct investor in a U.S. corporation by establishing a "level playing field" with regard to the U.S. tax imposed when the investor ultimately sells his interest in the company. In fact, the Congressional motive for the 1989 proposal may well have been even more narrow--that is, to inhibit foreign-investor-led "LBO" acquisitions of U.S. companies.

We understand that Title II of the current Bill, which reproposes sections 899 and 1447, also was introduced in order to establish a "level playing field" with respect to the U.S. taxation of stock dispositions. Unlike the 1989 proposal, however, we understand that Title II was not prompted by a desire to inhibit foreign-led LBOs of U.S. companies. Rather, Title II was introduced in response to a recent study tending to indicate that foreign-controlled U.S. corporations pay low U.S. corporate income taxes on rather significant gross receipts. Proposed Title II appears intended to compensate for these low corporate income tax receipts by taxing foreign direct investors on their dispositions of stock in such U.S. corporations.

We are gratified that Congress has removed the unilateral express treaty override and has improved the workability of the "investment partnership" rule contained in the 1989 proposal. Nonetheless, Title II in its present form continues to raise some of the same concerns as did the 1989 proposal with regard to its broad and far-reaching effects on international tax policy, the economy and U.S. tax laws. The following paragraphs summarize the concerns raised in our prior submission.

First, the proposal violates radically a long-standing and widely-held tenet of international taxation: that a taxpayer's sale of a company's stock generally should be taxed only by the country of the taxpayer's residence, not the country where the corporation is organized. This principle has been embodied in U.S. domestic tax laws since their inception; it is part of the domestic tax laws of most of our major trading partners;[4] and it is reflected in numerous tax treaties, including the U.S. Model Income Tax Treaty, the OECD Model Income Tax Treaty and existing U.S. income tax treaties with various countries. Unilaterally overriding a principle of such long standing and wide acceptance undoubtedly would be unwise from an international tax policy point of view.

The American Law Institute pointed out in 1986 that an international consensus may indicate the correct economic, theoretical or political result; that the U.S. needs the cooperation of other countries on important international tax matters, such as negotiating treaties, requesting information and obtaining help in enforcing U.S. tax laws, and resolving double-tax cases; and that inconsistency of international tax laws leads to gaps and overlaps in tax coverage, producing undesirable distortions of economic behavior. Proposed section 899 raises all of these concerns.

The effective dates, which would result in the imposition of U.S. tax on dispositions of stock acquired under prior law, are particularly troubling. These investments were based on existing U.S. law: the investors reasonably expected not to be subject to U.S. tax when they disposed of their investments. Since U.S. law followed the basic international norm, their expectations were well-founded. Taxing these investors now would be grossly unfair.

Second, the proposal will have wide-ranging and complex economic effects. Because of the difficulty inherent in drafting a provision narrow enough to affect only the targeted investors, the proposal undoubtedly will affect many other types of investors, who may be making the very types of investments that U.S. tax laws should promote rather than discourage. Because the proposal is so complex, it likely will deter many investors to whom it does not apply, simply because they are unsure whether the proposal applies to them. Also, the retroactive nature of the proposed tax will discourage many more investors to whom the tax does not apply, because they will fear that Congress may enact retroactively an adverse change in U.S. tax law that will affect their U.S. investments. At the House Ways & Means Committee hearings on foreign investment held earlier this year, a number of economists and other witnesses testified against any legislation that would discourage foreign investment.[5] Treasury Secretary Brady recently testified to the same effect.[6] Recent data indicate that other factors, such as the opening of Eastern Europe to commercial ventures, are acting to channel foreign investment elsewhere.[7] We are concerned that proposed sections 899 and 1447 will act to further discourage foreign investment in the U.S., and that domestic capital may not be available to take up the slack. Loss of this foreign capital would, of course, cause a loss of income to U.S. concerns and ultimately a loss of revenue to the U.S. fisc.

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[4] The domestic laws of India, Spain, the Netherlands, Australia, Italy, Japan, Austria, France, Canada and Germany impose tax on dispositions of stock in domestic corporations by certain non-resident aliens or foreign-corporations. Even in those countries, however, the stock-ownership threshold -- generally 25 to 40 percent -- required to trigger taxation usually is higher than the 10-percent threshold of proposed section 899. Moreover, in the case of U.S. shareholders, the tax is usually abrogated by treaty.

Finally, the proposal appears to interact with other provisions of U.S. tax law to affect the targeted investors in complex and possibly unintended fashions, and to affect other investors, such as portfolio investors, to whom the proposal was not directed.

In addition to the concerns discussed in our prior submission, we have the following concerns about some of the differences between sections 899 and 1447 as reproposed in Title II of H.R. 4308 and those sections as proposed for inclusion in the 1989 Act. First, the statutory anti-treaty-shopping provision, which requires an investor to be a "qualified resident" of a treaty country, overrides the limitation-on-benefits provisions of most United States income-tax treaties. Second, the Bill's "prospective override" of any treaty not in effect on March 20, 1990 prohibits the United States from negotiating future treaty provisions with respect to the proposed section 899 tax. This provision would significantly tie the hands of our representatives in future treaty negotiations. In addition, the technical effects of these limited overrides add further weight to the policy concerns of our prior submission with respect to the desirability of adhering to the long-standing and widely-held tenet that gain from the sale of stock should be sourced at the seller's residence, not in the country where the corporation is organized. Accordingly, we recommend that, even

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[3] "Ways and Means Considers Foreign Investment in U.S.," 46 Tax Notes 493 (January 29, 1990).

[6] Statement of Nicholas F. Brady, Secretary of the Treasury, before the Committee on Ways and Means, U.S. House of Representatives, April 18, 1990.

[7] Wall St. J., July 5, 1990, at 1, col. 6.

if proposed sections 899 and 1447 are enacted, these limited overrides should be omitted from the treaty-coordination provision.

Third, because current law recharacterizes liquidation or redemption distributions as dividends when appropriate, subsection (e) of proposed section 899 is unnecessary. In addition, subsection (e) would be contrary to existing substantive treaty obligations, and would violate the nondiscrimination provisions of existing treaties. Accordingly, even if some version of proposed section 899 is enacted, we recommend that subsection (e) should not be included.

Fourth, if Title II is enacted, we are gratified that the investment partnership exception has been improved, but we remain concerned that the venture capital exception, which was dropped, continues to be needed. Finally, we point out several aspects of proposed section 1447 that raise concerns, particularly the arbitrary nature of the "zero-basis" penalty and the need for coordination with existing withholding regimes, possibly by way of revising existing section 1445 to encompass the withholding provisions of proposed section 1447.

The balance of this submission presents in detail our comments on the differences between Title II of the Bill and sections 899 and 1447 as proposed for inclusion in the 1989 Act. Because of the concerns described below and in our prior submission, we continue to believe that Congress should not enact Title II of the Bill.

A. New Treaty-Coordination Rule.

Bill section 203(f)(3) provides that proposed sections 899 (other than subsection (e)) and 1447 shall not apply to any disposition by a "qualified resident" of a foreign country if application of such sections would conflict with the provisions of any treaty between the United States and such foreign country.

We are pleased that the Bill's sponsors have generally chosen not to include the deferred override provision contained in the version of section 899 that was proposed for inclusion in the 1989 Act. Nonetheless, we are concerned about two aspects of the new treaty-coordination provision. First, the provision requires a foreign investor to be a "qualified resident" of the treaty country in order to obtain the benefits of a treaty and thus escape the proposed section 899 tax. This statutory anti-treaty-shopping provision overrides the limitation-on-benefits provision included in most United States income-tax treaties.

Second, the provision overrides any treaty not in effect both on March 20, 1990 and at the time of the investor's disposition of stock in the United States company. This "prospective override" effectively prohibits the United States from negotiating future treaty provisions that ameliorate the proposed section 899 tax.

The following paragraphs describe these two concerns in more detail, and then describe how these limited overrides for non-qualified residents and future treaties exacerbate the policy considerations pointed out in our prior submission with respect to the desirability of adhering to the long-standing and widely-held tenet that gain from a sale of stock should be sourced at the seller's residence, not in the country where the corporation is organized.

1. The Statutory Anti-Treaty-Shopping Provision.

According to the Bill's treaty-coordination provision, a foreign corporation can claim a treaty benefit with respect to the proposed section 899 tax only if the foreign corporation is a qualified resident of the treaty country, as defined in Code section 884(e)(4). The limitation-on-benefits provisions in our most modern treaties differ in material respects from the provisions of Code section 884(e) and the regulations thereunder.[8] Therefore, a foreign taxpayer that satisfied the

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[8] The temporary regulations under Code section 884(e) treat a foreign corporation as a qualified resident if it meets any of the following tests: (a) the corporation meets (1) a stock ownership test (50 percent or more in vote and value held, directly or indirectly, by any combination of individual residents of the treaty partner and individual U.S. residents or citizens) and (2) a base erosion test (less than 50 percent of corporation's income used to meet liabilities to persons other than treaty country residents or U.S. residents and citizens); (b) its stock (or the stock of its 100-percent parent) is primarily and regularly traded on an established securities market in the United States or the treaty country; (c) the foreign corporation is engaged in an active trade or business in its country of residence, it has a substantial presence in its country of residence (an average of 25 percent and a minimum of 20 percent of its worldwide assets, income and payroll) and the U.S. income is an integral part of its active business in the treaty country; or (d) it obtains a ruling. Temp. Treas. Reg. § 1.884-5T.

By contrast, Article 17 of the recently signed treaty with Spain extends treaty benefits to additional corporations. First, a person is entitled to benefits under the treaty if that person is a non-profit organization or tax-exempt organization. Second, a corporation is entitled to benefits for income derived in connection with the active conduct of a trade or business within Spain, with no substantial-presence or integral-part tests but with an exception for investment companies other than banks and insurance companies. Third, the base erosion test applies to treaty test for entitlement to benefits, but not the statutory test, would be subject to proposed sections 899 and 1447. In such a case, the statute overrides the treaty entitlement provisions.

Moreover, the treaty-override aspect of these statutory anti-shopping rules will undermine the United States' bargaining position in ongoing treaty negotiations. Any advantage gained in exchange for the loss of bargaining power seems slight, because virtually all of our treaty partners are willing to negotiate limitation-on-benefits provisions. Our most modern treaties, including the recently signed treaties with the Federal Republic of Germany, Spain and India, which await Senate ratification, all contain comprehensive limitation-on-benefits provisions, and we have successfully negotiated protocols with France and Belgium that contain such provisions. Furthermore, according to the Technical Description, "the Bill contemplates that in the future all treaties will contain treaty-shopping provisions similar to those in some of the more recently negotiated treaties." The Bill's statutory override of our most recently-negotiated limitation-on-benefits provisions is inconsistent with its drafters' contemplation that future treaties will contain such provisions.

Because limitations on entitlement to treaty benefits are properly the subject of treaty negotiations, we believe that those limitations should not be overridden by statute. If Congress is concerned that some older treaties may contain limitation provisions permitting treaty-shopping 10-percent shareholders to evade the proposed section 899 tax, the first step should be to attempt to negotiate protocols to those treaties to prevent this result. If such negotiations are unsuccessful, a limited treaty override might be appropriate. In such situations, section 899 could define the term "qualified resident" as a person entitled to the benefits of a treaty in any case in which the treaty contains a limitation-on-benefits provision the terms of which apply to alienation of capital assets.[9] If a treaty did not contain a limitation-on-benefits

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payments to slightly different categories of persons. Fourth, a corporation can be a qualified resident if there is substantial and regular, but not necessarily primary, trading in its stock in a recognized stock exchange of Spain, the United States or any other exchange agreed on by the competent authority. Fifth, a corporation can qualify if more than 50 percent of its stock (not 100 percent) is owned directly or indirectly by a publicly traded company.

[9] Under this alternative test, the provisions of a treaty with an old-fashioned "investment company" limitation-on-benefits provision would not apply, since such a provision typically limits benefits relating to interest, dividends and royalties, but imposes no limits on benefits relating to capital gains.

clause, then the Code section 884(e) definition of "qualified resident" could apply. In order to avoid treaty overrides to the extent possible, however, we recommend that negotiations be undertaken prior to legislative action.

If, as the Technical Description indicates, the House leadership believe that a uniform anti-shopping standard should apply regardless of the anti-shopping provisions of individual treaties, and if that standard is the standard reflected in our "more recently negotiated treaties," then Congress could amend section 884(e) to make its provisions consistent with those "recently negotiated" treaties; alternatively, Congress could enact a treaty-coordination provision for proposed section 899 that conforms to the anti-shopping provisions found in these "recently negotiated" treaties.[10]

2. Prospective Override of Future Treaties.

Under the Bill, proposed section 899 would override a treaty that was not in effect both on March 20, 1990, and at the time of the investor's disposition of stock in the U.S. company. This appears to effectively prohibit the Treasury from negotiating future treaty provisions with respect to the tax imposed by section 899. We have doubts as to the Constitutionality of such a "prospective" statutory treaty override. Moreover, as

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See, *e.g.*, U.S.-U.K. Treaty, Article 16.

[10] Congress should indicate whether the Treasury should seek to negotiate provisions granting the U.S. primary taxing jurisdiction in this area or whether the treaty-coordination provision is intended primarily for foreign investors not entitled to tax treaty protection. For example, Article 13(4) of the new treaty with Spain would permit the U.S. to impose the proposed tax, but with a 25-percent stock ownership threshold. Article 13 of the new treaty with India generally would permit each country to tax capital gains. The cases of the United Kingdom and Australia also need consideration. Our treaties with those countries permit the imposition of tax on capital gains, but both treaties were negotiated on the understanding that neither in fact imposed tax on capital gains of foreigners and consultations would be held in the event this situation changed. We understand that the United Kingdom will seek a protocol restricting the application of proposed section 899 to U.K. companies, at least so long as the United Kingdom does not impose tax in the converse situation. It is not clear whether the Treasury Department would be free to negotiate such a protocol in light of the Bill's prospective override of future treaties. We also note that although the United Kingdom did not raise any public objection to FIRPTA, including the imposition of tax on stock in U.S. real property holding corporations, it will resist U.S. taxation of other capital gains.

Assistant Treasury Secretary Gideon recently pointed out, even though Treasury welcomes expressions of Congressional desires in order to develop appropriate negotiating positions,[11] there is no reason to remove from the Treasury's array of bargaining chips a position that may be used to gain beneficial concessions from foreign governments in future treaty negotiations. In addition, the primary practical effect of this prospective statutory treaty override would fall upon two of our important trading partners, the United Kingdom and Australia, because our treaties with those countries do not contain provisions that would abrogate the proposed section 899 tax. There is no logical reason why these two countries, alone among our major trading partners, should be singled out for unfavorable treatment. For these reasons, we believe that such a "prospective" statutory treaty override should not be enacted.

3. Effect of Limited Overrides for Non-Qualified Residents and Future Treaties.

In our prior submission, we stated that the tax imposed by the version of section 899 proposed for inclusion in the 1989 Act, with its deferred treaty override, would be borne in many cases by foreign governments, not their subjects. That is, a foreigner who paid the new U.S. tax often might be allowed a corresponding foreign tax credit against his taxes in his home country. Accordingly, that country would collect less tax, while the U.S. collected more. In these cases, the tax is not a tax on the affected foreign investors, but a tax on their governments.

The version of proposed section 899 included in the Bill continues to effect such a unilateral shift in taxing jurisdiction from a foreign jurisdiction to the U.S. in the case of a foreign investor not entitled to the benefit of a treaty, either because the investor's home country does not have a treaty with the U.S. that was in effect on March 20, 1990 and at the time of a disposition of stock, or because the investor is not a "qualified resident" of the treaty country.

As a general rule, the United States enters into income tax treaties with countries that impose rates of tax comparable to and in many cases higher than U.S. rates of tax on capital gains. In most cases, those countries impose a tax on gains recognized by their residents (both individuals and corporations) upon the sale of direct investments in the United States. They do not distinguish between qualified and non-qualified residents. It follows that imposition of a U.S. income tax upon the gains of non-qualified residents at the least constitutes a unilateral transfer of taxing jurisdiction from the foreign country to the United States, assuming the foreign country allows a credit against such tax.[12] As we pointed out in our prior submission, the Congress should not lightly enact legislation that unilaterally shifts tax revenue to the United States.

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[11] Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, before the Senate Committee on Foreign Relations, June 14, 1990.

For the reasons stated above, we believe that even if proposed section 899 is enacted, the limited statutory overrides for non-qualified residents and future treaties should not be included in any final bill.[13]

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[12] In cases where the foreign country does not allow a credit for the proposed new U.S. tax, the imposition of the tax can result in double taxation. For example, the foreign country may treat the sale of stock in a U.S. corporation as sourced within the foreign country. In such a case, the foreign country generally will not allow a foreign tax credit either because (i) the country has in place a foreign tax credit mechanism, but allows the credit only for taxes imposed on foreign-source income; or (ii) the country has no foreign tax credit mechanism, but rather relies on a system that exempts foreign-source income from domestic taxation. Accordingly, the gain would be subject to taxation by both the U.S. and the foreign country. Also, even if the foreign investor's home country allowed a foreign tax credit for the proposed section 899 tax, section 899 would result in an increase in tax liability in any case in which the home country's tax rate was lower than the U.S. tax rate. In these cases, therefore, while proposed section 899 in some ways may create a "level playing-field" with respect to the U.S. tax imposed on foreign and U.S. investors' dispositions of stock in the same U.S. company, it will distort the playing-field with respect to taxes imposed on the foreign investor's stock investments: the foreign investor will be taxed by his home country at one rate on dispositions of all foreign or domestic stock except stock in U.S. companies; on dispositions of stock in a U.S. company, however, he will be taxed by his home country at that same rate and in addition he will pay either the excess of the U.S. rate over his home country's lower rate or, if his home country allows no foreign tax credit, the entire U.S. tax.

[13] Even if Congress were to enact a statutory anti-treaty-shopping provision, we believe that such a provision should include an exception for a foreign investor claiming the benefits of a treaty in a foreign country that imposes a tax greater than 90 percent of the maximum U.S. rate to which the gain would be subject by reason of proposed section 899. Such an exception is found in current section 954(b)(4) with respect to the computation of the foreign base company income of a controlled foreign corporation. A similar exception would be appropriately included in a statutory anti-treaty-shopping rule for proposed section 899, because a foreign investor who has "shopped" for a treaty with such a country has not done so with a tax-avoidance purpose.

B. Treatment of Distributions in Liquidation or Redemption of Stock Held by Treaty Country Residents.

Subsection (e) of proposed section 899 would treat certain gains from the constructive exchange of stock in a liquidation or redemption transaction as dividends to the extent of the liquidating corporation's earnings and profits, in any case where application of subsection (a) would be barred by application of the treaty.

This provision forces treaty residents to sell stock in a domestic corporation to third parties rather than back to the corporation, despite the fact that such transactions produce functionally identical economic results.

> Example: F, a foreign person resident in Treaty Country X, owns all of the stock of domestic corporation D. F's stock has an adjusted basis of $1,000. D has earnings and profits of $10,000; its sole assets consist of $11,000 in cash or unappreciated property. If D liquidates and distributes all of its cash or property to F, F will suffer a dividend withholding tax of between 5 percent and 15 percent, depending on the rate in the treaty with X. If F sells the D stock to R (who can be a U.S. or a foreign person) for $11,000, F will be exempt from tax under the treaty. Note that R can then liquidate D. The distribution of cash or property by D will be treated as an exchange by R for D's stock but under the above facts R's gain will be zero.

Although this transaction might be viewed in certain circumstances as a device to avoid the rule of subsection (e), it would be extremely difficult to craft an anti-device provision to distinguish abusive from non-abusive transactions, because the application of proposed subsection (e) is based on the simple determination of the identity of the person who purchased the stock from the taxpayer. If that person is the corporation, subsection (e) applies; otherwise, it does not.

Domestic U.S. law[14] currently recharacterizes liquidation or redemption distributions as dividends in certain cases. Proposed subsection (e), on the other hand, would recharacterize liquidation or redemption gains as dividends in all cases where the taxpayer is a non-resident alien or foreign corporation. Because U.S. law already provides universal rules for such recharacterization without regard to the taxpayer's identity, proposed subsection (e) is unnecessary and overrides treaty provisions by which the U.S. has agreed not to tax such gains.

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[14] For example, sections 302, 304 and 306.

The Technical Description states that "[i]t is understood that [dividend] treatment [for liquidating distributions] is often accorded by treaty countries to amounts received by U.S. persons, consistent with U.S. treaty language prohibiting tax on gains." These countries, however, apply this treatment to all recipients of such distributions, including their own domestic taxpayers. Because proposed subsection (e) would apply such treatment only to foreign investors, the provisions would be inconsistent with U.S. treaty obligations.[15]

Furthermore, because proposed subsection (e) would work its recharacterization only in the case of foreign taxpayers, it clearly violates the non-discrimination provisions of existing treaties. The Technical Description states that proposed section 899(e) is not discriminatory because the foreign taxpayer is not similarly situated with a U.S. taxpayer. The Technical Description argues that the foreign taxpayer is not similarly situated with a U.S. taxpayer because when a foreign shareholder receives a distribution in liquidation or redemption from a U.S. corporation, that distribution may permanently remove U.S. corporate earnings from U.S. shareholder-level taxing jurisdiction, while such a distribution to a U.S. shareholder retains the corporate earnings within U.S. taxing jurisdiction. This argument ignores the fact that the foreign taxpayer from a treaty country is subject to a foreign tax system at rates which are comparable to or higher than U.S. tax rates. Although tax treaties benefit taxpayers in the sense that they seek to avoid double taxation of the same economic income, the principal purpose of tax treaties is to coordinate the allocation of taxing jurisdiction. Accepting the Technical Description's argument that a U.S. taxpayer and a foreign taxpayer are not similarly situated merely by reason of the fact that income is removed from U.S. jurisdiction even though it is taxable by the foreign country would render most non-discrimination provisions meaningless.[16]

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[15] The parenthetical in Bill section 203(f)(3) is difficult to reconcile with the Technical Description. Read with this parenthetical, section 203(f)(3) in effect states that "subsection (e) . . . shall apply to any disposition if such disposition is by a qualified resident of a foreign country and the application of [subsection (e)] would be contrary to any treaty between the United States and such foreign country . . ." (emphasis added). This provision clearly states that subsection (e) overrides contrary treaty provisions. The Technical Description, however, states that subsection (e) is not intended to override an existing treaty if the courts decide that the Bill's change in the definition of "dividend" "go so far as" to be inconsistent with the substantive provision of a treaty or a non-discrimination provision.

[16] The Technical Description accompanying the Bill expresses the drafters' views concerning the proper interpretation of U.S. law

In summary, because current law recharacterizes liquidation or redemption distributions as dividends when appropriate, subsection (e) is unnecessary. In addition, subsection (e) would be contrary to existing substantive treaty obligations, and would violate the nondiscrimination provisions of existing treaties. Accordingly, even if some version of proposed section 899 is enacted, we recommend that subsection (e) should not be included.

C. New Partnership Exception.

1. The Proposed Statute.

Proposed section 899(b)(3)(A) treats each foreign partner of a partnership that owns more than 10 percent of the stock of a domestic corporation as a 10-percent shareholder of that corporation if more than 10 percent of the capital or profits interests in the partnership is held directly or indirectly by non-resident alien individuals or foreign corporations.

Proposed section 899(b)(3)(B) creates an exception allowing foreign partners of certain diversified investment partnerships to claim "look-through" attribution treatment with respect to stock owned by the partnership. If, at all times during the five years preceding the date on which the partnership disposed of stock of a domestic corporation, (i) the partnership did not own 50 percent or more (by vote or value) of the outstanding stock of that corporation, and (ii) the partnership's aggregate bases in its stock and securities of that corporation was less than 25 percent of the aggregate bases of all of the partnership's assets (excluding cash items and adjusted for partnership liabilities), each foreign partner is treated as owning only its proportionate share of the stock of that corporation actually owned by the partnership. The Treasury Department is authorized to issue regulations disregarding failures to satisfy the less-than-25-percent test (but not the

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relating to treaties. We believe Congress should be cautious about including such interpretations in legislative history of a statute. These interpretations are not authoritative to the extent that they express an opinion about the state of current law rather than the construction or interpretation of the bill under consideration. Moreover, our treaties (especially the more modern ones) provide for consultation between competent authorities where difficulties or doubts arise as to the application or interpretation of the treaty. See, *e.g.*, Article 26(3) of the unratified Spanish treaty; Article 28(4) of the unratified West German treaty. We should allow competent authority procedures to resolve questions concerning the scope of non-discrimination provisions, since this is the means most apt to result in an interpretation satisfactory to both treaty partners.

less-than-50-percent test) if the partnership "normally met such requirements during such 5-year period." In no case is the diversified partnership exception available, however, with respect to foreign partners that have owned more than 50 percent of the partnership's profits or capital interests at any time during that 5-year period.

2. Comparison with 1989 Proposal.

The version of section 899 proposed for inclusion in the 1989 Act contained two exceptions permitting foreign partners to claim look-through attribution treatment: an exemption for certain venture capital partnerships and a second "investment partnership" exception similar to the diversified partnership exception set forth in section 201 of the current Bill. The venture capital exception (i) was applicable only to stock of domestic corporations that were not public when the partnership acquired that stock, (ii) did not contain a less-than-50-percent limitation on the partnership's ownership of the outstanding stock of the issuer and (iii) allowed the partnership to qualify for the exemption if it satisfied the less-than-25-percent test now contained in the current Bill during any 90-day period (selected by the partnership) within the preceding 5-year period. To qualify for the investment partnership exception, a partnership would have been required to satisfy a less-than-25-percent test based on the fair market value of the stock of the domestic corporation relative to the total fair market value of its assets (other than cash items and adjusted for partnership liabilities), and a less-than-50-percent test applied to the stock of the domestic corporation on a class-by-class basis rather than to all of its outstanding stock.

The drafters of the current Bill dropped the venture capital exception, and improved on the investment partnership exception: they eliminated valuation problems by using cost bases rather than fair market values for purposes of the less-than-25-percent test, and reduced the adverse impact of the legislation on conventional financing transactions (in which special classes of preferred stock or convertible debentures frequently are issued to investors that participate in new rounds of financing) by applying the less-than-50-percent test to all outstanding stock of the domestic corporation rather than on a class-by-class basis. The drafters also corrected a technical problem with the 1989 proposal by requiring compliance with the less-than-25 and less-than-50 percent requirements during the shorter of the period in which the partnership held stock of the corporation or 5 years, rather than during the preceding 5-year period regardless of when the stock was acquired.

Finally, the drafters of the current Bill reduced the ownership percentage for purposes of determining whether a foreign investor is a 10-percent shareholder from "more than 10 percent" to "10 percent or more" stock ownership, and made a parallel change in the rule for determining whether the percentage of foreign ownership of a partnership is sufficient to warrant denying its foreign partners look-through stock attribution treatment.

3. Suggested Changes.

The elimination of the venture capital exception, and the resulting application of the less-than-50 percent stock ownership requirement to venture capital partnerships, would make it considerably more difficult for those partnerships that have foreign partners to engage in "seed" funding of start-up companies. It is common for venture capital partnerships to acquire more than 50 percent of the stock of small start-up companies, with the expectation of being diluted down in subsequent rounds of financing. Under proposed section 899(b)(3)(B)(II) in its present form, each foreign partner of a partnership that made such an investment would be subject to United States tax on gains realized when the partnership sold that stock, regardless of whether the partnership satisfied the less-than-25 percent diversification requirement, unless (a) the sale were deferred until 5 years had elapsed after the partnership's holdings of that company's outstanding stock had dropped below 50 percent by vote and value or (b) a treaty exemption from section 899 were available. Further, foreign partners seeking to claim treaty exemptions would be required, under section 6114, to forfeit their anonymity by making the "treaty-based return position" disclosures required by that section.

As a result, enactment of section 899 in the form proposed would deter foreign investors from becoming partners of venture capital partnerships, and also would effectively prevent any venture capital partnership with foreign partners from undertaking a seed financing of a domestic start-up company and acquiring 50 percent or more of the equity of the new corporation in exchange for its investment. We strongly recommend that the venture capital exception proposed for inclusion in the 1989 Act, or an equivalent exemption, be included in the current Bill to avoid disrupting a significant source of financing for small domestic corporations.

With respect to the diversified partnership exception contained in the current Bill, unless and until favorable regulations are issued the rules set forth in proposed section 899(b)(3)(B)(I) effectively would force an investment partnership with foreign partners to acquire the securities of its first 5 portfolio companies simultaneously, and to dispose of the securities of its last 5 portfolio companies simultaneously, in order to be certain of qualifying for look-through stock attribution treatment. This obviously would not be practical for most partnerships, and would be virtually impossible for partnerships investing in securities that are not publicly traded and therefore must be acquired in negotiated transactions.

Further, although the Treasury Department is authorized to issue regulations relaxing the requirements of the less-than-25 percent test during the start-up and wind-down periods of a normally-diversified partnership, past experience indicates it is extremely unlikely that such regulations will be issued before the withholding rules of proposed section 1447 go into effect. Since general partners are personally liable for under-withholding, the statute's reliance on regulations to be issued is likely to cause excessive withholding. This would create a substantial disincentive for foreign investors to acquire interests in partnerships, including venture capital partnerships, that invest in domestic corporations. Even foreign investors entitled to claim the benefits of a tax treaty to avoid both section 899 tax liability and section 1447 withholding might be reluctant to invest, since section 6114 would require those investors to file U.S. tax returns and forfeit their anonymity in order to obtain such benefits. Section 899 therefore should set forth specific, objective rules, perhaps similar to those set forth in the venture capital exception proposed for inclusion in the 1989 Act, providing reasonable flexibility to normally diversified investment partnerships in their start-up and wind-down periods.

Finally, under proposed section 899 a partnership that actually owns less than 10 percent of the stock of a domestic corporation may be treated as a 10 percent shareholder of that corporation if any of its partners (even those with very small minority interests) own stock of that corporation directly because, under the stock attribution rules of section 318(a)(3)(A), a partnership is treated as owning all stock owned by its partners. To avoid withholding tax liability under proposed section 1447 with respect to the partnership's disposition of any stock of a portfolio company that is not publicly traded, the general partners of a partnership whose foreign partners hold 10 percent or more of its capital or profits interests therefore would be required to obtain from each foreign partner that has not properly claimed a treaty exemption the affidavit described in proposed section 1447(b)(1)(A), even if the partnership qualifies for look-through attribution treatment under proposed section 899(b)(3)(B).

In addition, if the partnership does not qualify for look-through attribution treatment, its general partners effectively must obtain from each partner (not only foreign partners) a statement setting forth the amount of stock of that portfolio company (if any) held by such partner outside the partnership in order to determine whether the partnership is a 10 percent shareholder of that portfolio company. Obtaining such affidavits and statements prior to each disposition of stock of the portfolio company would be impossible in many cases and, to protect themselves if such affidavits and statements were not obtained, the general partners would be required to withhold tax with respect to foreign partners not entitled to treaty benefits.

As a result, enactment of the withholding rules of proposed section 1447 in their present form, in conjunction with proposed section 899(b)(3)(A), would create a substantial disincentive for foreign investors contemplating an investment in a venture capital or other partnership that invests in non-traded securities of domestic corporations. To avoid impairing the ability of such partnerships to raise capital from foreign investors, proposed sections 899 and 1447 should incorporate a *de minimis* rule: no tax should be imposed under proposed section 899, and withholding should not be required under section 1447, with respect to a foreign limited partner that owns a less-than-10-percent interest in the profits and capital of a limited partnership entitled to look-through attribution treatment under the investment partnership exception currently set forth in proposed section 899(b)(3)(B) or an exception for venture capital partnerships similar to that set forth in the version of section 899 proposed for inclusion in 1989 Act.

With such a *de minimis* rule, the foreign limited partner's disposition of stock in a U.S. corporation held directly still would attract U.S. tax and withholding in appropriate circumstances. The partnership, however, would not be required to ascertain the limited partner's direct stockholdings in the partnership's portfolio companies in order to determine whether to withhold when the partnership disposed of stock in those companies. Moreover, the limited partner would not have to aggregate his proportionate share of the partnership's stockholdings with his direct holdings in order to determine whether he was a 10-percent shareholder, in which case his disposition of directly-held stock would trigger the section 899 tax. A 10-percent threshold is appropriate because (i) many substantial foreign investors, in order to diversify and decrease investment risk, refrain as a matter of practice from acquiring 10-percent or larger interests in any investment entity and (ii) a less-than-10-percent threshold would be consistent with one of the apparent goals of proposed section 899--to subject to United States tax gains realized on stock sales by controlling foreign shareholders of domestic corporations--because a limited partner with a less-than-10-percent interest generally would not be able to control the partnership and would risk forfeiting its limited liability if it became involved in the management of the partnership.

D. Withholding Issues.

1. Summary of Differences.

In addition to the provisions proposed for inclusion in the 1989 Act, the Bill includes the following two provisions with respect to the withholding requirements of proposed section 1447:

(a) The Bill adds proposed section 1447(d)(4) which grants the Secretary authority to prescribe a reduced amount of withholding upon the request of the taxpayer or the withholding agent.

(b) The Bill expands proposed section 1447(c)(2) to permit the Secretary to reduce or eliminate the penalty aspects of such provision by allowing the foreign person's basis in the stock disposed of to be an amount greater than zero.

2. Comments.

(a) Zero basis if no withholding. Proposed section 1447(c) states that if withholding has not occurred and the foreign person does not pay the tax imposed, then for purposes of determining the amount of such tax, the foreign person's basis in the stock shall be deemed to be equal to zero. We are pleased that the drafters have made the correction that we suggested in our prior submission, by substituting the word "subtitle" for the word "chapter," so that the zero-basis penalty applies to determine basis in computing the foreign person's tax liability under proposed section 899, not his basis for purposes of determining the amount of the proposed section 1447 withholding tax.

As we stated in our prior submission, this zero-basis provision operates arbitrarily to impose a potentially huge penalty tax without regard to the amount of the foreign transferor's actual gain and his resulting tax liability under the substantive, non-penalty provisions of proposed section 899. The Bill's version of the zero-basis penalty allows the IRS to treat the foreign transferor's basis as any amount other than zero, thereby potentially ameliorating the arbitrary operation of the statutory provision. However, the proposed statute gives the IRS no guidance in exercising its discretion. Moreover, the parenthetical language stating that "for purposes of section 6501, the underpayment of such tax shall be treated as due to a willful attempt to evade such tax" emphasizes the penalty nature of the provision, implying that the IRS is free to treat basis as zero to buttress this penalty. In all but the most abusive cases, this zero-basis penalty would be confiscatory. Accordingly, we recommend that the proposed zero-basis provisions be revised to state that the IRS has discretion to treat basis as zero, or any other amount that is appropriate under the circumstances, if withholding has not occurred and the taxpayer's failure to pay the section 899 tax is due to willful neglect rather than reasonable cause. In addition, guidelines are needed in order to prevent a request of the Secretary in every case where the penalty would otherwise apply and to ensure that the penalty, if applied, will relate to the amount of actual gain. Moreover, guidelines are also necessary to avoid possible discriminatory treatment among different classes of foreign taxpayers.

(b) Relief from overwithholding. Proposed section 1447(a) requires the withholding agent to withhold tax equal to 10 percent of the amount realized on the taxpayer's disposition of stock. Although proposed section 1447(d)(4) grants the Secretary authority to prescribe a reduced amount of withholding upon the request of the taxpayer or the withholding agent, no guidelines are provided as to how such requests should be made. Until such guidelines are provided, rules similar to those currently set forth under section 1445(c) and Rev. Proc. 88-23 should apply to withholding under proposed section 1447 (for example, application procedures to obtain reduced withholding based on the maximum tax liability of the foreign taxpayer, and special rules applicable to installment sales).

(c) Coordination with Section 1446. Although proposed section 1447(a) provides for regulations coordinating the provisions of proposed section 1447 with sections 1445 and 1446, immediate guidance regarding coordination with section 1446 is required due to the strong likelihood of overwithholding. Specifically, gain on the disposition of stock by a partnership could be taxable to its foreign partners under section 1446 as effectively connected income and under section 1445 as gain on the disposition of a U.S. real property interest, as well as under proposed section 1447. Thus, overwithholding may result.

(d) Coordination with Sections 1441 and 1442. The draft statutory language should be revised to clarify whether withholding on a dividend described in subsection (e) of proposed section 899 is required under proposed section 1447 or under sections 1441 and 1442. The draft language of subsection (a) of proposed section 899 states that gain described in subsection (a) is to be taken into account under sections 871 and 882 as effectively-connected income attributable to a United States permanent establishment. The draft language of subsection (e) of proposed section 899, however, states merely that in the circumstances described in subsection (e), such gain shall be treated as a dividend to the extent of the earning and profits of the domestic corporation attributable to the stock. This draft language does not clearly state whether a subsection (e) dividend, like subsection (a) gain, is to be taken into account under sections 871 and 882 as effectively-connected income attributable to a United States permanent establishment, or whether a subsection (e) dividend is to be taken into account under the flat-rate withholding regime of sections 1441 and 1442.

The need for clarification of this issue is heightened by proposed section 1447, which apparently requires 10-percent withholding on any disposition of stock subject to either subsection (a) or subsection (e) of proposed section 899. Read together, therefore, the draft language of proposed sections 899 and 1447 could be interpreted to require withholding on a subsection (e) dividend under both proposed section 1447 and section 1441 (or 1442). Accordingly, the language of subsection (e) and proposed section 1447 should clarify which withholding result is intended.

(e) Proliferation of Withholding Regimes. Although it is not within the stated ambit of the Task Force, one cannot help but comment that if proposed section 1447 is enacted (along with proposed section 899), there will be no less than four separate, somewhat contradictory and extremely detailed withholding tax regimes contained in Chapter 2, Subchapter A ("Withholding of Tax on Nonresident Aliens and Foreign Corporations"). Certainly, under the banner of "simplification" (or simply common sense), this proliferation of withholding regimes should cease, and perhaps even be reversed in our annual tax-writing exercise. In that regard, and in order to avoid further complication, we recommend that the provisions of existing section 1445 be revised to include withholding on dispositions of stock by 10-percent shareholders. Revising 1445 in this fashion would allow reference to an established regime, thereby avoiding the possibility of difficulties such as those encountered by Congress and the IRS in fashioning administrable withholding provisions under section 1446, as well as guidance to implement those provisions. Moreover, revising section 1445 to cover dispositions of stock by 10-percent shareholders would avoid many of the coordination problems described above.

E. Non-recognition provisions.

In our prior submission, we stated that the prior Bill's version of proposed section 899(c), which would deny 10-percent shareholders the benefits of nonrecognition provisions until regulations were issued, was unworkable. We are pleased that the drafters of the current Bill have revised proposed section 899(c) to postpone denial of nonrecognition treatment until implementing regulations are issued, as we urged in our prior submission.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON INTERNAL REVENUE CODE SECTIONS 899 AND 1447 (AS ADDED BY SECTION 11404 OF THE REVENUE RECONCILIATION ACT OF 1989)

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by a Task Force of the Committee on U.S. Activities of Foreigners and Tax Treaties. Members of the Committee who submitted comments were (in alphabetical order) Benjamin Berk, Nicholas S. Freud (Committee Chair), Dean C. Gordanier, Jr., Barry J. London, Richard R. Schaul-Yoder, Leonard Schneidman (Task Force Chair), and Thomas S. Wisialowski. Questions may be directed to Leonard Schneidman (617) 482-1390 or Nicholas S. Freud (415) 421-1100. These comments have been reviewed by David S. Foster (415-442-1245) on behalf of the Committee on Government Submissions.

Dated: October 11, 1989

We are writing to offer our comments on proposed sections 899 and 1447 of the Internal Revenue Code, which are under consideration as section 11404 of the Revenue Reconciliation Act of 1989 (Title XI). Proposed section 899 would tax non-resident alien individuals and foreign corporations when they sell stock of any U.S. corporation in which they hold more than a 10-percent stake; proposed section 1447 would require withholding agents to collect the tax.

We understand that this proposal is neither intended nor expected to raise significant revenues. Rather, the proposal is intended to remove a perceived advantage of a foreign direct investor in a U.S. corporation, by establishing a "level playing-field" with regard to the U.S. tax imposed when the investor ultimately sells his interest in the company. And in fact, the Congressional motive may well have been even more narrow--that is, to inhibit a foreign-investor-led hostile "LBO" acquisition of a U.S. company. In its present form, however, the proposal would have broad and far-reaching effects on international tax policy, the economy and U.S. tax laws.

First, the proposal represents a radical change in a long-standing and widely-held principle of international taxation and involves serious issues of unilateral "overrides" of existing treaties. Second, while the proposal is intended to tax foreigners who are engaged in hostile takeovers of U.S. companies, we are concerned that the proposal will have far more wide-ranging and complex economic effects. Third, the proposal's interaction with other provisions of U.S. tax laws appears to affect even the targeted foreign investors in complex and possibly unintended ways, and to affect other foreign investors at whom the proposal was not directed.

For these reasons, we believe that Congress should not enact this proposal. The balance of this submission presents our comments in detail.

1. Principles of International Taxation; Treaty Overrides.

The proposal violates radically a long-standing and widely-held tenet of international taxation: that a taxpayer's sale of a company's stock generally should be taxed only by the country of residence, not the country of source. This principle has been embodied in U.S. domestic tax laws since their inception; it is part of the domestic tax laws of most of our major trading partners;[1] and it is reflected in numerous tax treaties, including the U.S. Model Income Tax Treaty, the OECD Model Income Tax Treaty and existing U.S. income tax treaties with various foreign countries.

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[1] A few countries tax certain nonresident-alien and foreign-corporation shareholders on sales of stock in domestic corporations, but even in these countries the tax is usually

Congress in effect reaffirmed and broadened this principle in the Foreign Investors' Tax Act of 1966 (the "1966 Act"), on the recommendation of a task force appointed in 1963 by President Kennedy to study foreign investment in the United States.[2] In the Tax Reform Act of 1986, Congress undertook a serious reconsideration of the Internal Revenue Code's foreign tax provisions, and left in place the rules reflecting long-standing international tax policy, including the principle that capital gains generally should be taxed only by the country of residence, not the country of source. In fact, the 1986 enactment of the branch profits tax shows that Congress recognized the continuing validity of the principle. Moreover, the recent Federal Income Tax Project of the American Law Institute recommended continuing adherence to this principle.[3]

Unilaterally overriding a principle of such long standing and wide acceptance undoubtedly would be unwise from an international tax policy point of view. The American Law Institute's 1986 proposals stated three reasons for adopting internationally-acceptable U.S. tax laws: first, an international consensus may indicate the correct economic, theoretical or political result; second, the U.S. needs the cooperation of other countries on important international tax

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abrogated by treaty in the case of U.S. shareholders.

[2] The 1966 Act broadened the principle in several ways: first, the Act eliminated a provision for taxation of capital gains realized by a non-resident alien individual when he is physically present in the United States; second, the Act extended from 90 to 183 days during a taxable year the time that a nonresident alien individual may spend in the U.S. before becoming subject to U.S. tax on U.S.-source capital gains that are not effectively connected with the conduct of a trade or business within the U.S.; third, the Act clarified that a nonresident alien individual or foreign corporation investing in the U.S. will not be deemed engaged in a trade or business because of activity in an investment account or by granting a discretionary investment power to a U.S. employee, broker, custodian, or other agent; fourth, the Act provided that a nonresident alien individual or foreign corporation engaged in a trade or business in the U.S. will be taxed on capital gains at regular rates only if these gains are effectively connected with the conduct of the U.S. trade or business.

[3] Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons, May 14, 1986.

matters, such as negotiating treaties, requesting information and obtaining help in enforcing U.S. tax laws, and resolving double-tax cases; finally, inconsistency of international tax laws leads to gaps and overlaps in tax coverage, producing undesirable distortions of economic behavior. Proposed section 899 raises all of these concerns.

The express treaty override proposed for section 899, in particular, is certain to impair Treasury's ability to negotiate tax treaties and to damage the relatively cooperative nature of international relations with regard to tax matters. Several articles in the foreign financial press, for example, have highlighted the proposal. The proposed three-year grace period during which it is expected that Treasury will renegotiate existing treaties is unlikely to mitigate these adverse foreign-relations aspects of a unilateral treaty override. Moreover, the language implementing the grace period raises questions as to whether a particular treaty is a "comprehensive income tax treaty" and otherwise makes it difficult to determine whether an investor is entitled to the grace period.

Practically, the enactment of this proposal would have two effects on international taxation. First, in many cases the tax would be borne by foreign governments, not their subjects. Second, the proposal may initiate retaliatory legislation, the economic burden of which would be borne by the U.S. Treasury, not by taxpayers. A foreigner who paid the new U.S. tax often may be allowed a foreign tax credit against his taxes in his home country. Accordingly, that country would collect less tax, while the U.S. collected more. In these cases, the proposal is not a tax on the affected foreign shareholders, but a tax on their governments. Because of this, those governments are likely to retaliate with similar, reciprocal taxes on Americans who own stock in foreign companies. Those retaliatory taxes, too, would be borne in many cases by the U.S. government, and not by the affected U.S. shareholders in the foreign companies, because of the U.S. foreign tax credit. Because the U.S. still is a net exporter of capital, the U.S. fisc would be the loser in this reciprocal tax regime, because it would forgo more taxes (in the form of the foreign tax credit) than it collected as a result of proposed section 899.

We are especially troubled by the effective dates of the proposal. In general, the affected foreign investors would be taxed on their sales of stock in U.S. companies after the end of this year, regardless of when they acquired the stock. These investments were based on existing U.S. law: the investors reasonably expected not to be subject to U.S. income tax when they disposed of their investments. Since U.S. law followed the basic international norm, their expectation was well-founded. Taxing these investors now would be grossly unfair.

2. Economic Policy.

We understand that the proposal is intended to tax foreigners who engage in hostile takeovers of U.S. companies. We fear, however, that the proposal in its current form will have far more wide-ranging and complex economic effects, for a number of reasons. We are not economists, but in our practices we deal directly with investors. We have based our comments regarding the likely effects of proposed section 899 on our experiences with these investors. First, because of the difficulty inherent in drafting a provision narrow enough to affect only the targeted investors, the proposal undoubtedly will affect many other types of investors, who may be the very types of investors that U.S. tax laws should promote rather than discourage.

Second, because the proposal is so complex, it likely will deter many investors to whom it does not apply, simply because they are unsure whether the proposal applies to them. The 1963 Presidential Task Force noted that complex tax laws are themselves a deterrent to foreign investment.[4]

Third, the retroactive nature of the proposed tax certainly will discourage many more investors to whom the tax does not apply, because they fear that Congress may enact retroactively an adverse change in U.S. tax law that will affect their U.S. investments.

Fourth, as described above, our trading partners likely would enact reciprocal taxes on American investors; and because the U.S. still is a net exporter of capital, the net effect would be a revenue drain: the U.S. would forgo more taxes (in the form of the foreign tax credit) than it collected from the new proposal.

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[4] [T]he actual fiscal impact of this or any other tax law on the persons to whom it applies does not measure the extent to which the law deters or limits potential investment by persons who are unwilling or unable to master its complexities. This is especially true when dealing with foreigners, whose familiarity with U.S. laws and practices is limited. Even those foreigners with substantial funds available for investment often find it troublesome and expensive to obtain sound U.S. tax advice, with the result that they channel their investments elsewhere.

Report of the U.S. Task Force on Promoting Increased Foreign Investment (in United States Corporate Securities) and Increased Foreign Financing (for United States Corporations Operating Abroad), 1964, at 25.

3. Effects Under U.S. Tax Laws.

Purely from the point of view of the consistency of internal U.S. domestic tax policy, there is no reason why foreign investors should enjoy an exemption from taxes paid by U.S. investors when they sell stock in a U.S. company. Nonetheless, as described above, considerations of international policy and economics historically have dictated otherwise. Moreover, the current proposal appears to interact with other provisions of U.S. tax law to affect the targeted investors in complex and possibly unintended fashions, and to affect other investors to whom the proposal was not directed.

The following paragraphs describe some of the technical problems with the proposal that we have noted.[5]

(a) Potential effects on portfolio investments. Proposed sections 899 and 1447 may adversely affect foreign portfolio investors, as described below. It would be very surprising if such adverse effects were intended by Congress in a section of the tax law aimed expressly at "direct" rather than portfolio investments by foreign investors.[6] These adverse effects may be caused by the direct application of proposed section 899 as well as by the application of the proposed attribution rule.

(i) Direct effects of proposed section 899. Offshore Investment Funds ("OIFs") and other foreign corporations are by far the most popular vehicle for foreign portfolio investment in the U.S. Most of these vehicles, including the U.K. investment trust, are treated as corporations for U.S. income tax purposes. Accordingly, if such an OIF holds more than 10 percent of a U.S. corporation, the OIF will be subject to tax under section 899 when it disposes of any of that stock.

Moreover, the constructive ownership rules of proposed section 899(b)(2) in many cases will treat an OIF as owning stock held by related OIFs. In these cases, an OIF may be treated as holding more than 10 percent of the stock of a U.S. corporation, even though its direct holdings are substantially below the 10-percent threshold. For example, if OIF "A" owns 5 percent of the stock of a U.S. corporation, and OIF "B" owns 10 percent or more in value of OIF A's stock, then OIF A will be treated under proposed section 899(b)(2)(B)(ii) as owning OIF B's stock in the U.S. corporation. If OIFs A and B together hold more than 10 percent of the U.S. corporation's stock, then OIF A will be subject to tax under section 899 when it disposes of any of that stock.

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[5] The House Ways and Means Committee's "Explanation of Title XI, Revenue Provisions, of House Ways and Means Committee's Budget Reconciliation Recommendations, as approved by the House Budget Committee, September 19, 1989" (hereinafter, the "Ways and Means Committee Explanation"), acknowledges some of the problems discussed below.

[6] The usual line of demarcation for a direct investment is 10 percent of voting power. See, for example, section 127 of the Tax Reform Act of 1984, repealing withholding on portfolio interest, and the provisions of the International and Trade in Services Survey Act requiring Department of Commerce reporting in the event of foreign direct investments in the United States.

(ii) Portfolio investments affected by the proposed attribution rule. Proposed section 899(b)(3)(A) provides that if a partnership is a 10-percent shareholder in a domestic corporation, and more than 10 percent of the capital or profits interests in the partnership are held by nonresident alien individuals or foreign corporations, then each partner is treated as a 10-percent shareholder with respect to the corporation. Proposed section 899(b)(3)(E) provides that similar rules shall apply in the case of a pass-thru entity other than a partnership. Proposed section 899(e)(2) provides that the Secretary may issue regulations aggregating stock held by a group of persons acting together. Under these provisions, section 899 may be interpreted to apply to RICs and other domestic pass-thru vehicles, which are common vehicles for foreign portfolio investments. Thus, for example, if a RIC holds more than 10 percent of the stock of a U.S. corporation, each foreign shareholder will be subject to tax under section 899 when the RIC disposes of any of the stock, no matter how small such shareholder's pro rata interest in the fund. It is unclear whether regulations would apply rules similar to the proposed investment partnership exception in the case of a RIC; it is also unclear whether this exception, if it were to apply, would be broad enough to exempt RICs from the general attribution rules. Application of section 899 to RICs almost certainly will discourage foreign investment in these funds.

Moreover, the regulations "aggregating stock held by a group of persons acting together" could interpret section 899 to apply to a group of unrelated foreign investors who invest through the same U.S. broker or adviser. Under this interpretation, if the broker or adviser made a "buy" recommendation and, as a result, the foreign investors placed orders such that together they held more than 10 percent of the stock of a U.S. corporation, any later disposition of the stock within 5 years of that date would be subject to tax under section 899.

(b) Stock investments by partnerships. Section 899(b)(3) treats each foreign partner of a partnership that owns more than 10 percent of the stock of a domestic corporation as a 10 percent shareholder of that corporation if more than 10 percent of the capital or profits interests in the partnership are held by nonresident alien individuals or foreign corporations, subject to two exceptions for diversified partnerships.

(i) Venture capital exception. The venture capital exception generally allows each foreign partner to be treated as owning only its proportionate share of stock of a portfolio company that is actually owned by the partnership if the basis of that stock is less than 25 percent of the partnership's aggregate basis in its corporate stock and securities. The exception applies only to stock of companies that were not public when that stock was acquired, and is available if the diversification requirement is satisfied either on the date of disposition or during any 90-day period (selected by the partnership) within the shorter of the period during which the partnership held that stock or the preceding 5-year period. Under these rules, foreign partners of a partnership which generally is diversified may obtain look-through attribution treatment with respect to the stock of a particular corporation even if the partnership's holdings exceed the 25 percent threshold during certain periods (e.g., during its start-up and wind-down phases).

The House Ways and Means Committee Explanation states that the Committee intends generally to permit partnerships qualifying for the venture capital exception to treat foreign partners that own less than 10 percent of the partnership's capital and profits interests as though such partners were not 10 percent shareholders for purposes of tax withholding. Proposed section 1447, however, contains no provision implementing this statement of intent.

(ii) Investment partnership exception. Foreign partners of a partnership which acquires more than 10 percent of the stock of a company that was public when that stock was acquired must rely on a second, "investment partnership" exception to avoid being treated as 10 percent shareholders.

This exception generally allows look-through attribution treatment with respect to such stock if the partnership owns less than 50 percent of such stock and, in addition, the fair market value of that stock does not exceed 25 percent of the fair market value of the partnership's assets (other than cash and cash items) at any time during the 5-year period ending on the date of disposition. The statute provides no explicit relief for partnerships which fail this test because of fluctuations in the market values of their assets, or for partnerships in the start-up or wind-down phases. Instead, it authorizes the Secretary of Treasury to issue regulations disregarding failures to meet this diversification if the partnership "normally met such requirements during such 5-year period."

(iii) Suggested changes. By its terms, the investment partnership exception does not apply to any partnership that has been in existence for less than five years. This cannot have been intended, and should be corrected.

In addition, until and unless favorable regulations are issued, (1) partnerships investing in volatile public securities that acquire more than 10 percent of the stock of any domestic corporation cannot assure their foreign limited partners that they will not be treated as 10 percent shareholders, and (2) any such partnership effectively will be forced to acquire stock of its first 5 portfolio companies simultaneously, and to dispose of the securities of its last 5 portfolio companies simultaneously when it liquidates, if it hopes to qualify for look-through attribution treatment. Past experience indicates that the Treasury is extremely unlikely to issue such regulations before the withholding rules of proposed section 1447 go into effect. As a result, the statute's reliance on regulations to be issued is likely to cause excessive withholding (since general partners are personally liable for underwithholding) and will create a substantial disincentive for foreign investors to acquire interests in partnerships that invest in public companies. The investment partnership exception therefore should include specific, objective diversification rules dealing with changes in asset values due to stock market volatility and other factors beyond the control of the partnership, and also should set forth rules (perhaps similar to those contained in the venture capital exception) providing reasonable flexibility to partnerships in the start-up and wind-down periods.

Finally, proposed section 1447 should be revised to implement Congressional intent by including a provision explicitly exempting partnerships qualifying for the venture capital exception from being required to withhold tax under that section with respect to allocations or distributions to their less-than-10 percent foreign partners.

(c) Branch profits tax. The Tax Reform Act of 1986 imposed the branch profits tax in order to equalize the U.S. tax treatment of a foreign corporation operating as a branch in the U.S. with that of a U.S. subsidiary of a foreign corporation. Generally, the branch profits tax created an incentive for a foreign corporation to operate in the U.S. through a U.S. subsidiary. Under the proposal, however, a foreign corporation which establishes a U.S. subsidiary will be subject to a capital gains tax when it liquidates or otherwise disposes of its U.S. subsidiary. By contrast, Treasury regulations provide that the complete termination of a branch generally is not subject to the branch profits tax. In apparent recognition of this interaction, the Ways and Means Committee Explanation states that the Committee expects Treasury to amend the branch tax regulations so as to impose the branch profits tax on a foreign corporation's complete termination of its U.S. branch. Assuming that Congress enacts proposed section 899, this result will further equalize the U.S. tax treatment of a foreign corporation operating as a branch in the U.S. with that of a U.S. subsidiary of a foreign corporation. Nonetheless, as described above, considerations of international tax policy and domestic economic policy dictate against the enactment of proposed section 899.

(d) Definition of stock. Proposed section 899 applies to the disposition of "stock" in a domestic corporation. Proposed section 899(d) provides that certain options, convertible debt, and, to the extent provided by regulations, other interests (other than an interest solely as a creditor) will be treated as stock for purposes of section 899. This raises complicated debt/equity characterization issues, and creates an incentive for foreign persons to structure investments in U.S. companies as hybrid debt, i.e., a debt instrument bearing interest and a share of appreciation in underlying equity. This issue already has caused significant concern in the implementation of the tax rules governing foreign real estate investments in the United States (i.e., FIRPTA). Moreover, these complications are exacerbated by the Act's proposals to treat high-yield original issue discount debt instruments as stock (Act §11202, proposing new IRC §386) and to authorize regulations that will treat certain instruments as in part stock and in part debt (Act §11208(a), amending IRC §385).

(e) Impact on U.S. real estate structures. After the Tax Reform Act of 1986, foreign persons acquiring interests in U.S. real estate typically form a foreign holding company with a U.S. subsidiary, which owns the underlying U.S. real estate. Generally, this structure results in the imposition of a single U.S. tax when the real estate is sold and the U.S. corporation liquidates: the U.S. corporation is subject to corporate tax on the gain, but the stock of the U.S. corporation is not treated as a United States real property interest and is purged of its "FIRPTA taint" under section 897(c)(1)(B). Thus, under present law, the foreign holding company is not subject to a second tax on liquidation of the U.S. corporation. Proposed section 899 would subject the foreign holding company to a second tax on the liquidation of the U.S. subsidiary. Thus, section 899 will have an adverse impact on the tax planning for foreign investment in U.S. real estate.

(f) Coordination with nonrecognition provisions. Proposed section 899(c), which would deny 10-percent shareholders the benefits of nonrecognition provisions until regulations are issued, is unworkable. Denial of nonrecognition treatment should be postponed until implementing regulations are issued, so that it does not become necessary for 10-percent foreign shareholders to avoid participating in corporate recapitalizations and other normal tax-free transactions until the Treasury Department reduces its regulations backlog. In general, stock exchanges occurring in the course of tax-free reorganizations, section 1036 exchanges, and other nonrecognition transactions should not result in current tax provided that the foreign investor is a 10-percent shareholder before and after the transfer and receives no boot, so that tax is deferred and not avoided. This approach is consistent with that of sections 1445 and 897(e) (FIRPTA), on which section 899(c) appears to be modeled.

As drafted, section 899(c) also contains a presumably unintended twist of language. Proposed section 899(c)(1)(A) provides that, except as provided in subparagraph (B), no nonrecognition section shall apply for purposes of section 899. Proposed section 899(c)(1)(B) provides that the Secretary shall prescribe regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes providing the extent to which the nonrecognition provisions shall apply. This statutory language creates the curious rule that the nonrecognition provisions will apply only where necessary to prevent the avoidance of Federal income taxes. Based on this language, the nonrecognition rules never would apply, because nonrecognition rules are never necessary to prevent tax avoidance: that is, nonapplication of the nonrecognition rules insures that a foreign person disposing of stock at a gain in a transaction subject to section 899 always will recognize, and become subject to tax on, such gain. We assume that this result was not intended.

(g) Withholding Issues.

(i) Coordination with Code Section 1446. Coordination with section 1446 is required because of the constructive ownership rules of proposed section 899(b)(2)(A). If the income allocable to a foreign partner is effectively connected income ("ECI") under proposed section 899, and the income is therefore treated as ECI at the partnership level, the partnership will be required to withhold under section 1446. In addition, withholding under proposed section 1447 will apply. Thus, overwithholding may result.

(ii) Relief from Overwithholding. Proposed section 1447 does not include section 1445(c)-type relief. As a result, overwithholding may result. Rules similar to the relief currently provided under section 1445(c) and Rev. Proc. 88-23 should apply to proposed section 1447 (i.e., reduced withholding based on the maximum tax liability of the foreign taxpayer and the special rules applicable to installment sales).

(iii) Withholding agent. The last U.S. person in the chain, rather than the buyer of the shares in the domestic corporation, is designated as the withholding agent. In some cases a number of U.S. persons reasonably may consider themselves to be the last in the chain. Furthermore, if there is no such U.S. person, regulations are to provide ordering rules as to who is the withholding agent. Until these ordering rules are promulgated, a number of possible withholding agents may exist. Clarification is needed as to which ordering rules will govern in order to prevent multiple withholding.

(iv) Exemptions from Withholding. Because a withholding agent is exempted from withholding only if the transferor furnishes an affidavit that the transferor is not a foreign person, the transferor is not a 10-percent shareholder, or the stock is qualified venture capital stock to which proposed section 899 does not apply, the withholding agent will be required to collect an affidavit with respect to virtually every stock transaction. Proposed section 1447 should be expanded to permit the withholding agent to rely on "any other means" of determining whether withholding is required, as permitted in sections 1445 and 1446.

(v) The "Reason to Know" Standard. It will be difficult to determine when a withholding agent has "reason to know" that the transferor is a foreign person with 10 percent or more ownership. Clarification is needed as to what the withholding agent must do in order to discharge its obligation in determining whether a transferor is a foreign person. A rule similar to that of section 1445(b)(7) would provide the withholding agent with more certainty, by allowing the agent to rely on an affidavit unless he has actual knowledge that it is false or receives notice that it is false.

(vi) One-Percent Dispositions of Publicly Traded Stock. The requirement to withhold where more than one percent of publicly-traded stock is disposed of will slow the transfer process significantly. For this reason, the drafters of FIRPTA decided to exempt dispositions of publicly-traded stock from withholding. A similar exemption appears to be warranted in this case. In fact, since both section 1445 and proposed section 1447 relate to withholding on dispositions of stock, it may be appropriate to enact proposed section 1447 as a new subsection of section 1445, and to adopt the current section 1445(b)(6) exemption for dispositions of stock that is regularly traded on an established securities market.

(vii) Zero basis if no withholding. Proposed section 1447(c) states that if withholding has not occurred and the foreign person does not pay the tax imposed by "this chapter," then for purposes of determining the amount of "such tax," the basis in the stock shall be deemed to be equal to zero. Since proposed section 1447(c) would be enacted as part of chapter 3 of the Internal Revenue Code, the tax imposed by "this chapter" is the proposed section 1447 withholding tax. This provision appears to cause the foreign person's basis to be deemed to be zero for purposes of determining the amount of the withholding tax. The foreign person's basis, however, does not affect the amount of the withholding tax, which is equal to 10 percent of the amount realized. The proposed statutory language should be clarified to indicate that the zero-basis provision applies for purposes of determining the foreign person's tax liability under proposed section 899 (for example, by substituting the words "chapter one" for "this chapter" in proposed section 1447(d)(2)).

This zero-basis penalty operates in unusual ways. For example, a shareholder who sold stock for an amount no greater than his basis would not be subject to tax under proposed section 899, so that the zero-basis penalty would not be triggered by lack of withholding. On the other hand, a shareholder who sold at a $1 gain would be subject to tax under section 899, and lack of withholding and payment of the negligible section 899 tax could trigger a zero-basis penalty equal to millions of times the tax involved. The zero-basis provision also likely violates the anti-discrimination clauses of U.S. tax treaties.

(viii) Constructive ownership rules. In order to comply with the withholding rules of proposed section 1447, a foreign investor seeking to sell shares in a domestic corporation (as well as the prospective buyer and all other potential withholding agents with respect to the transaction) would be required to ascertain whether the investor was a 10 percent shareholder of that corporation. The attribution rules of proposed section 899(c)(2) effectively would require each mutual fund or other corporation in which the foreign investor directly or indirectly held more than 10 percent of the stock to determine whether it had owned any stock, options or convertible debt of the domestic corporation at any time during the five years preceding the date of disposition, and to notify the investor. Mutual funds generally do not make such detailed reports available to investors, and the proposed statute imposes no penalty on a mutual fund that is not a withholding agent if it fails to provide the necessary information to its more-than-10-percent foreign shareholders. Foreign investors unable to obtain accurate information will not be able to ascertain and satisfy their U.S. tax liability, and therefore could become subject to the penalty imposed by proposed section 1447(c) even if they used their best efforts to obtain the necessary information. A relief provision seems warranted.

We respectfully recommend that Congress should not enact proposed sections 899 and 1447.

Multistate Tax Commission

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Ways and Means
Subcommittee on Oversight

August 3, 1990

The Honorable J.J. Pickle
Chairman, Oversight Subcommittee
House Ways and Means Committee
1105 Longworth HOB
Washington, DC 20515-6348

Dear Mr. Chairman:

Your subcommittee recently held two days of hearings on potential under reporting of income to the IRS by foreign controlled businesses. The Multistate Tax Commission and its member states are deeply concerned about the underreporting of income to the IRS because (1) of direct effects - the under reporting of income to the federal government gives rise to under reporting of income to the states and (2) indirect effects--reductions in federal revenues give rise to increased responsibilities on the states.

A principal focus of the hearings was a review of the IRS's administration of the arm's-length audit standard required by Section 482 of the IRC. This issue is of concern to the states and the MTC because at the urging of the federal government the states have placed their reliance on federal audit efforts. The testimony presented to the committee suggests this reliance may prove to be misplaced.

Section 482 Non-compliance is a breach of faith to the states:

First, let me provide the historical context for the MTC's concerns about the IRS's lack of resources in this area. In 1983, then President Ronald Reagan authorized then-Treasury Secretary Donald Regan to establish the Worldwide Unitary Taxation Working Group to develop voluntary, cooperative solutions to disputes concerning state use of the worldwide unitary combination apportionment method of determining the taxable income of multinational corporations. Working Group members included representatives of multinational businesses, the states, and the federal government. In an effort to resolve the decades-old controversy over the use of the arm's length method versus worldwide unitary combination, the state members agreed to support "water's edge" unitary combination *if* the federal government made specific improvements in federal tax compliance and cooperation with the states.

At the time, 12 states were using the worldwide combination method for determining taxable income. A short two years later, a majority of those states had begun to recede from full use of worldwide combination. Currently, Alaska is the only state that requires the use of worldwide combination. Otherwise, worldwide

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combination remains as only an elective or optional method of acccunting in a handful of states. This movement by the states accomplished in two years what two decades of proposed federal restrictions could not. It clearly shows that states took the Working Group process seriously, and made a good faith effort to comply with the principles contained in the report. But good faith efforts have not been matched by an equivalent level of federal activity. Implementation of the Working Group's Principle Two -- the increased federal assistance -- has been conspicuously lacking.

The 1984 report that Secretary Regan sent to the President made this proposal:

> In order to demonstrate the good faith and sincere intentions of the federal government, I am proposing at this time that the Treasury Department move immediately to implement the federal assistance measures recommended by the Working Group...[Working Group Report, p.iii]

But what has been implemented to date? The IRS has invited limited numbers of state tax staffs to attend their training courses on international issues. There has been a marginal increase in the number of international examiners and the initiation of examination of foreign controlled taxpayers. But there is no discernible increase in IRS audit activity, merely a shift in emphasis. Furthermore, high turnover in IRS staff has given rise to a lack of experienced field personnel attempting to audit highly complex business transactions while being hampered by taxpayers' use of international boundaries and obfuscation. The results do not appear to be what they should be. What benefits have been provided to the states?

Treasury also committed to involve the states in a re-examination of the efficacy of the transfer pricing approach. While Treasury has undertaken such a step, it has not involved the states and more significantly, it seems to have been based on the premise that the arm's length approach is the only solution. It assumed that what was required was tinkering and adjustments rather than a reconsideration of a method which has proved unadministrable.

Finally, the most significant compliance tool from a state perspective was to be the Domestic Disclosure Spreadsheet. But this has not been enacted at the federal level.

States Increasingly Dependent on IRS for Information on Multinationals:

Since the states agreed to the Working Group proposals and voluntarily adopted water's edge unitary combination, they have become increasingly reliant on the IRS for information on taxable income from multinational corporations. In a practical sense, the states generally base their water's edge unitary combination on IRS data collected from multinationals. If the IRS does not have adequate resources to collect that information and income is being underreported, it follows that states' taxable income figures will be lower. The federal government is not the only loser from underreporting; it has substantial impact on state revenue collections as well.

The states have a strong financial stake in having the IRS fully and correctly determine the taxable income of foreign-owned U.S. companies. We support adequate funding for the IRS. But, we ask such funding be accompanied by the IRS fulfilling its commitment to the Working Group report by increasing federal assistance to the states.

Non-compliance of Section 482 demonstrates inherent problems with arm's length:

Historically, the states have had serious concerns about the reliability of separate accounting using the arm's length method to determine taxable income. During the recent hearings by the Oversight Subcommittee, IRS officials staunchly defended the arm's length method for determining taxable income. One exception, a former IRS employee, testified that the arm's length standard exists in a world of "smoke and mirrors" where no one knows what the phrase means and that market place assumptions clearly do not work where the market place is controlled. The MTC shares similar concerns and believes the problems with Section 482 are due in large part to the inherent problems with the arm's length method.

For approximately 75 years, the states have been involved with determining taxable income of multistate and multinational businesses. Based on decades-old experience on this issue, the states came to rely on a formulary apportionment approach as the most accurate method to determine taxable income. The arm's length method has problems because it:

1. is administratively complex given the millions of transactions that must be reviewed to audit on an arms-length basis;
2. is not an internationally-accepted standard since, while most industrial nations have signed tax treaties committing themselves to the arm's length theory, the rules and level of implementation are not uniform; and,
3. does not accurately reflect the manner in which multinational enterprises operate and earn their income.

As a result, the method permits multinational businesses to artificially shift profits from high to low tax jurisdictions, and permits multinational businesses to shift reported income artificially so that it escapes taxation. Abuses of transfer pricing by foreign-owned U.S. companies is a good example of the flaws of the arm's length method. Consequently, separate accounting has been criticized by Congress' General Accounting Office and others for failing to provide consistent, equitable measurement of income.

Separate accounting works when activities are in fact separate, not integrated. With the changes in the European markets due to implementation of EC 1992 and the dramatic changes in the Eastern bloc countries, there will be even more integration, rather than less. Thus, calculating taxable income by separate accounting methods will become even more artificial and complex in the years ahead. In response to concerns about greater complexity, earlier this year, U.S. tax experts recommended that the European Community look at formulary apportionment as an alternative because it does "...involve much greater administrative ease for taxpayers and administrations alike." (Howard Liebman quoted in the BNA Tax Reporter, 2/8/90).

Federal experience with the arm's length method demonstrates the administrative problems it poses because of the difficulty of determining arm's length prices. The MTC believes the arm's length method is conceptually flawed because it fails to account for synergistic profits or to reflect the way businesses actually operate.

Using the arm's length approach, every transaction that occurs between related corporations must be examined to determine if the price charged for the service or goods reflects what would have been charged if the companies were not related and instead were dealing at "arm's length". But often, there is simply no evidence of what an arm's length price for a product or service might have been. Some examples of the types of transactions that are difficult to determine include transactions on copyrights, patents, royalties or unique tangible goods. Overhead and administrative charges such as legal, advertising and accounting services are also problematic. Despite the need for an exhaustive examination of a multitude of transactions for every corporation, the IRS often must rely on guesstimates in order to determine the arm's length price.

Because of the states long-standing experience in the area of taxation of multi-jurisdictional businesses, we have amassed considerable knowledge and expertise with these problems. At the request of the federal government, states have become linked to the use of 482 transfer pricing methodology. Therefore, the Multistate Tax Commission would be pleased to assist the Oversight Subcommittee as you move forward in your examination of the abuses in transfer pricing and other compliance issues with IRC Section 482. The Commission or its member states would be willing to participate in any continuing studies of this subject.

Sincerely yours,

John James

John James
Chairman

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STATEMENT OF THE ORGANIZATION FOR THE FAIR TREATMENT OF INTERNATIONAL INVESTMENT FOR SUBMISSION TO THE HOUSE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

August 3, 1990

The Organization for the Fair Treatment of International Investment ("OFTII") is composed exclusively of U.S. companies who are subsidiaries of foreign corporations. OFTII was established in 1984, and a list of the members of OFTII who are interested in the issues before the Subcommittee is attached to this statement as Exhibit A. Most of the OFTII members are engaged in manufacturing in the U.S.. They employ several hundred thousand U.S. citizens and have contributed billions of dollars to the U.S. economy. These direct investments and interests in the U.S. are for the long term and reflect the faith that foreign interests have in the vitality and security of the U.S. as a major player in the emerging global economy.

In recent testimony before another Subcommittee of the Congress, a Treasury Department official pointed out that basic U.S. policy toward foreign investment has been the same for the past 200 years. As applied by all Administrations since Alexander Hamilton was Secretary of the Treasury, the U.S. policy has been to welcome foreign investors and to treat foreign investors similarly to their domestic counterparts once they are operating in the U.S. economy. While stating that foreign direct investment is still a very small part of the overall U.S. economy, this official cited a number of statistics showing the significant positive contributions of foreign-owned firms. Data from the Bureau of Economic Analysis (BEA) indicate that in 1987, the non-bank affiliates of foreign firms[1] employed 3.2 million Americans; had payrolls of $94 billion; paid $9.4 billion in U.S. income taxes; and spent $6.2 billion on research and development. (See Statement of John M. Niehuss Senior Deputy Assistant Secretary of the Treasury for International Economic Policy before the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the Committee on Energy and Commerce, U.S. House of Representatives, July 31, 1990.)

The members of OFTII are U.S. corporate citizens and as such accept their responsibility of paying their fair share of U.S. taxes. These members wholeheartedly support the fair administration of the tax code by the Internal Revenue Service (IRS) and neither endorse nor condone tax evasion.

The Subcommittee has reviewed the tax returns of 36 foreign-owned companies and appears to believe that there are problems with the level of tax compliance by some of these companies. OFTII members do not know whether any OFTII member companies were among the 36 companies examined by the Subcommittee, but recognize that in any segment of taxpayers there may be some who are not reporting their income properly. We support the efforts of the IRS to audit taxpayers and make appropriate adjustments when taxpayers, foreign or domestic, have not properly reported income.

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[1] BEA includes U.S. companies which have 10 percent or more foreign ownership, while the IRS uses a 25 or 50 percent threshold in its foreign-controlled definitions.

What deeply concerns OFTII members is that sweeping generalizations about the level of tax compliance by all foreign-owned companies are being made on the basis of the examination of 36 companies -- less than one percent of all foreign-owned companies. Beyond the small sample size, the selection criteria for this group were clearly targeted toward a group of companies that the IRS has already targeted for audit; i.e., Japanese-owned motor vehicle and electronics companies. That such a small and potentially biased sample should be the basis for major tax policy decisions affecting international investment in the United States is statistically indefensible and unwise from a policy standpoint.

We commissioned KPMG Peat Marwick to prepare a study of taxes paid by all foreign-owned companies for the 1983 through 1986 period, the most recent period for which data were publicly available at the time the work was completed. A copy of that study and a summary of its findings are attached as Exhibit B.

The study, which was based on IRS Statistics of Income data, showed that foreign-owned companies paid, on average, a slightly higher U.S. effective tax rate than U.S.-controlled companies based on assets, net worth, or positive net income over the 1983 through 1986 period.[2] Effective tax rates of foreign-owned companies dropped dramatically in 1986. The study suggests one possible reason for this decline was the rapid fall in the value of the dollar in 1986, a drop of over 21 percent. Even though foreign-owned companies experienced a dramatic fall in their income in 1986, they still paid over $3 billion in federal income taxes, a fact that is often overlooked.

The Peat Marwick study found a number of factors suggesting that 1986 was not the beginning of a downward trend in net income and tax liability for foreign-owned companies, but was, rather, an isolated occurrence. As we subsequently learned at the Subcommittee hearings, the net income of foreign-owned companies rebounded from a loss of $1.5 billion in 1986 to a gain of $5.4 billion in 1987.

The data released in the testimony of IRS Commissioner, Fred T. Goldberg, and Assistant Secretary of the Treasury, Kenneth W. Gideon, at the Subcommittee hearings was consistent with the 1983 through 1986 data in Peat Marwick study. Data from 1987 tax returns presented in their testimony were not previously publicly available, and thus were not part of the Peat Marwick study.

At this time, the limited 1987 data included in the IRS and Treasury testimony are the only 1987 information available. Using these figures we have updated the U.S. effective tax rate on assets from the Peat Marwick study and found that over the 1983 through 1987 period, the U.S. effective tax rates experienced by U.S.-controlled and foreign-owned corporations were virtually identical (.55 percent for foreign-owned and .57 percent for U.S.-controlled companies). There was not enough 1987 data released at the Subcommittee hearings to update the other effective tax rates reported in the Peat Marwick study.

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[2] Effective tax rates based on assets and net worth, as described in the Peat Marwick study, include both firms with income and firms with losses. The effective tax rate on positive net income includes only firms with net income. The Subcommittee is particularly interested in analyzing the implications of foreign-owned firms with losses, thus the use of effective tax rates on assets or net worth is a more appropriate measure to use.

It is unfortunate that both the IRS and Treasury Department testimony omitted any real discussion or analysis of the actual taxes paid by foreign-owned companies. Nor did they provide a meaningful comparison of effective tax rates incurred by foreign-owned companies with those of U.S.-controlled companies. As the Subcommittee Members are well aware, effective tax rates are a standard measure used by tax policy analysts to assess whether similarly situated taxpayers incur the similar tax burdens.

The IRS testimony did not include the actual amount of taxes paid by foreign-owned companies, while the Treasury Department testimony contained only one chart showing that foreign-owned companies paid $4.5 billion in tax in 1987 – a fifty percent increase over the taxes paid in 1986.

The Treasury Department testimony did include a table with effective tax rates on total receipts, which it correctly reported as being lower for foreign-owned companies than U.S.-controlled companies in 1987. This comparison is perhaps the least useful measure of effective tax rates it could have chosen. Total receipts is a measure of the volume of business conducted by a corporation; however, receipts will vary tremendously from industry-to-industry and from company-to-company within an industry in a way that is totally unrelated to the extent of a firm's compliance with current tax laws.

On the other hand, we would expect a comparison based upon net worth to be more consistent across industries and companies. For example, if we look at all corporations filing tax returns in 1987 and pick the same industries included in the Treasury Department testimony, we find the following:

	Effective Tax Rate on Receipts	Effective Tax Rate on Net Worth
Motor vehicle manufacturing	0.55%	2.30%
Motor vehicle wholesale	0.75%	4.88%
Motor vehicle retail	0.12%	2.81%
Household appliance manufacturing	1.59%	4.39%
Consumer electronics manufacturing	0.99%	2.46%
Electronic component manufacturing	1.08%	2.99%
Sporting goods wholesale	0.60%	6.60%
Electrical goods wholesale	0.77%	5.95%
All other	0.95%	2.20%
Total	0.91%	2.20%

The ratio of the highest to the lowest effective tax rate on receipts is 13.3 (a range from 0.12 percent to 1.59 percent), while the ratio of the highest to the lowest effective tax rate on net worth is 3.0 (a range from 2.20 percent to 6.60 percent). This wide disparity in effective tax rates on total receipts is more a measure of the relative capital intensity of the business and the extent of vertical integration within an industry than a measure of tax avoidance or evasion.

Clearly, because these data are for all companies filing tax returns with IRS and not just foreign-owned companies, the variation in effective tax rates is more likely the result of true economic differences rather than manipulations of the tax system.

Rather than focus upon effective tax rates, the IRS and Treasury Department testimony focused upon a comparison of the rates of return on assets and on receipts of foreign-owned companies compared to U.S.-controlled companies. The Peat Marwick study contained much of the same data that demonstrates the tendency of foreign-owned companies to have a lower rate of return on assets or on net worth, than U.S.-controlled companies. The Peat Marwick study did not present comparisons of a rate of return based on receipts because, as we have stated, we do not believe using receipts as a measure across broad industry categories is as relevant as using assets or net worth. While all the data indicate that the foreign-owned companies have a lower rate of return (based on assets, net worth or receipts), none of the data indicates why. Simply having a low rate of return does not automatically indicate tax evasion.

Both the IRS and Treasury Department testimony specifically state that the aggregate data simply do not indicate widespread tax cheating by the foreign-owned companies. (See IRS testimony at page 8 and Treasury Department testimony at page 5.) As this testimony clearly stated, there could be any number of explanations for the lower rates of return. It may indicate that foreign-owned companies, as a whole, are investing more rapidly in plants and equipment and thus have disproportionately high depreciation or amortization costs. It may also be that foreign-owned companies are more highly leveraged than U.S.-controlled companies or perhaps less profit-driven due to having lower capital costs.[3] Both the IRS and Treasury Department cautioned the Subcommittee that the aggregate data do not demonstrate that the lower rates of return are the result of the manipulation of transfer prices. (Id.)

No one appears to know why the foreign-owned companies have a lower rate of return, and the publicly available data do not allow anyone to do an analysis to find the answers. Only the IRS, Treasury Department, and certain committees of the Congress have the data to address these questions, and we think it would be appropriate to answer these questions before publicly announcing that all foreign-owned companies are using transfer pricing to lower their taxable incomes unfairly. They may have low taxable income for many other reasons.

OFTII members are concerned that the Subcommittee will be tempted to react to anecdotal data, presented behind closed doors and without opportunity for explanation, and recommend legislation which will adversely affect all foreign-owned companies and investments. A more thorough analysis of the aggregate data should be conducted to determine whether and to what extent legislation is necessary to curb abuses. Thus, we urge the Subcommittee to look at the appropriate aggregate data before making recommendations for legislation, and not to base their recommendations solely on the perceived actions of 36 taxpayers who do not appear to be representative of all foreign-owned companies.

While the members of OFTII do not endorse all of the recommendations of the IRS and Treasury Department, we do commend these agencies for focusing their testimony upon the problems in enforcing Section 482, rather than launching an attack on foreign-owned companies generally or suggesting radical and unilateral changes in the arm's length standard used in transfer pricing cases. Indeed, both the IRS and the Treasury Department cited the importance of pursing a balanced enforcement strategy and cautioned the Subcommittee about acting unilaterally in the Section 482 area. (See IRS testimony at page 3 and Treasury Department testimony at page 10.)

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[3] To the extent that there may have been a problem with over-leveraging by foreign-owned companies, it has been addressed in the 1989 Budget Reconciliation Act by enactment of IRC Section 163(j), the "earnings stripping" provision.

The testimony presented at the Subcommittee hearing suggested a number of problems in the enforcement of Section 482, for both foreign-owned and domestic-based taxpayers. Legislation was enacted just last year whose purpose was specifically described as to "improve enforcement of Section 482." The new reporting and recordkeeping requirements of Section 6038A are targeted at foreign-owned companies, and indeed, many OFTII members are still apprehensive about what the new recordkeeping requirements will be and how the new penalty provisions will be applied. The problems in enforcement which were described at the hearings occurred prior to enactment of these new provisions. It is likely that many of the problems would not have arisen if the IRS previously had the new powers given to it last year in Section 6038A. Thus, it seems especially important to assess the effectiveness of these new provisions before crafting additional legislation to deal with the enforcement of Section 482.

Above all, we hope that the Subcommittee will move with extreme caution in recommending any changes in the arm's length standard. The U.S. was the leader in establishing this standard and in getting the major industrialized nations of the world to agree to follow it. It would be a shocking turn of events to abandon this standard now, solely because there are some difficulties in administering it. Any changes in the arm's length standard would have to apply to transfer pricing arrangements between U.S. parent corporations and their foreign subsidiaries as well. In addition, any changes should respect the existing treaties between the U.S. and its trading partners, as well as the ongoing GATT negotiations, if the U.S. wants to continue to be a respected leader in the international community. Furthermore, several of the witnesses at the hearing pointed out, the risk of retaliation by our trading partners against U.S. companies doing business abroad is serious.

The members of OFTII believe that Section 482 is administrable and that most foreign-owned companies are trying to comply with the arm's length standard. If, however, the Congress concludes that even after enactment of the 1989 amendments to Section 6038A, there is more than a mere enforcement problem with Section 482 and that the arm's length standard needs to be abandoned, the appropriate method for doing so would be through multilateral agreements with our trading partners, not by a unilateral action of the U.S.. It should be noted that the British Chancellor of the Exchequer, John Major, has recently written to the Secretary of the Treasury proposing such a multilateral approach to any perceived compliance problems in the transfer pricing area. (See Exhibit C.)

Respectfully submitted by,

James Merle Carter
Secretary of OFTII

[THE ATTACHMENTS TO THIS STATEMENT ARE BEING RETAINED IN THE COMMITTEE FILES]

Sony Corporation of America
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Park Ridge, New Jersey 07656
Telephone (201) 930-6100

N. Vander Dussen
President
Chief Operating Officer

August 3, 1990

Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
House Ways & Means Committee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Pickle:

At the July 12 hearings of the Oversight Subcommittee you were told that Sony may have failed to comply with the tax laws of the United States. The source of these allegations was a letter written to three members of Congress by Mr. Maurice Kupritz, a former Sony employee. Mr. Kupritz's letter contained numerous misrepresentations and inaccuracies that I believe must be clarified.

There is no truth to Mr. Kupritz's charges. It has always been Sony's firm policy to fully comply with all U.S. laws. In particular, our tax returns have always been prepared in compliance with IRS regulations. Moreover, like many other U.S. corporations, Sony's tax returns for past years have been and continue to be routinely audited by the IRS.

Given these facts, it is distressing that the baseless allegations of a disaffected former employee should become the subject of testimony before a Congressional committee.

Mr. Kupritz's letter was brought to our attention in a floor speech by Senator Helms, who had written to the Sony Corporation in Tokyo regarding Mr. Kupritz's letter. As requested, I responded promptly to Senator Helms. A copy of my reply is attached for inclusion in the subcommittee's hearing records.

Sony Corporation of America and its employees are proud of the reputation for quality, innovation, and integrity which we have worked hard to attain in our thirty years of doing business in the United States. We are dismayed that unfair and baseless allegations are damaging this reputation.

I appreciate this opportunity to clarify these issues, and ask that this letter be made a part of the record of the proceedings.

Respectfully submitted,

N Vander Dussen

N. Vander Dussen
President and
Chief Operating Officer

NVD:tmb
Attachment

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N. Vander Dussen
President
Chief Operating Officer

July 6, 1990

The Honorable Jesse A. Helms
United States Senate
403 Senate Dirksen Office Building
Washington, D.C. 20510-3301

Dear Senator Helms:

Mr. Akio Morita asked me to respond to your June 27 letter concerning correspondence that you received from Mr. Maurice Kupritz. In his letter, Mr. Kupritz accused our Company of failing to comply with the laws of the United States. You asked for our response. I have also read your Senate floor statement of June 28, which reiterated that request. I shall address each of your questions in turn, however, I regret that we did not have an opportunity to respond to your letter before your June 28 statement.

1. "Was Mr. Kupritz an employee of Sony America and did he hold the position that he indicated?"

Response: Mr. Kupritz was briefly employed for ten months by Sony Corporation of America, from August 29, 1988 to June 30, 1989. Contrary to his claims, however, Mr. Kupritz was not Director of "Government Compliance". He was a mid-level manager with responsibility for supervising routine portions of our import and export activities through a network of independent customs brokers and freight forwarders. His job did not encompass taxation or accounting matters.

Contrary to his claims, Mr. Kupritz was not terminated on "trumped-up charges". He was terminated as a result of an investigation conducted pursuant to our Company's policy against sexual harassment after a female subordinate of Mr. Kupritz lodged what proved to be a well-founded complaint against him for violations of that policy. On May 14, 1990 the complainant filed a civil lawsuit against Mr. Kupritz alleging battery, personal injury, and sexual harassment, among other things. I hasten to add that Sony played no role in the initiation of this lawsuit.

Several months after his termination, and after we denied his demands for reinstatement, Mr. Kupritz filed a civil lawsuit against Sony for wrongful termination, including various other charges, among them violation of constitutional rights, libel, and slander. This litigation is still pending. Thereafter, Mr. Kupritz also filed an age discrimination charge against Sony with the State of New Jersey. That charge is also pending. Further, it is my understanding that Mr. Kupritz has filed an unrelated legal action against another former employer, Bristol-Myers.

2. "Is it true that Sony America reported 'revenues of $8 billion and profits of only around $10 million (for 1988)?' If this is not true, would you supply me with the correct figures?"

Response: The amount of revenues and profits stated by Mr. Kupritz in his letter are erroneous. As to the correct amount of revenues and profits, Sony Corporation of America has made full and accurate reports to the Internal Revenue Service and other governmental agencies as required by law.

3. "What is the procedure that Sony America uses to report account information to its parent firm?"

Response: Sony Corporation of America reports account information in accordance with standard accounting practices. In his letter, Mr. Kupritz makes a vague reference to what he terms "service charges" running between Sony America and Sony Tokyo. Although we can only speculate as to what he means by this claim, we believe that Mr. Kupritz was referring to numerous inter-company agreements between Sony Tokyo and Sony America by which Sony Tokyo, in the vast majority of cases, reimburses Sony America for certain specific expenses. In some cases, Sony America pays Sony Tokyo reasonable fees related to our use of patents, trademarks and know-how in our extensive U.S. manufacturing operations. There is nothing nefarious or underhanded about these agreements, which have been given to the Internal Revenue Service in connection with their routine examinations of Sony Corporation of America's federal tax returns. Mr. Kupritz' suspicions can only have been caused by his lack of familiarity with such transactions.

4. "Is there any validity to the charges leveled in the Kupritz letter?"

Response: No. Mr. Kupritz' letter makes a number of reckless charges concerning this Company. Not one of these charges is true. His false claims respecting this Company's alleged non-compliance with U.S. tax laws are particularly troubling. Like many other U.S. companies, Sony Corporation of America's annual federal tax returns are carefully examined by the Internal Revenue Service on a routine basis.

In addition, Mr. Kupritz made what we have determined to be a spurious charge that he was instructed to destroy a memorandum critical of the Company. We believe the memo he refers to was actually written to in-house counsel and was very general in nature, e.g., Mr. Kupritz began by saying, "The purpose of this memo is to ensure that SONAM is in compliance with Section 1059A of the 1986 Tax Code". More importantly, the memo contained not a single mention of any particular problem, shortcoming, or element of wrong-doing. Finally, when questioned by our counsel upon receipt of the memo, Mr. Kupritz was not able to identify any particular problem which he wished to raise.

We appreciate this opportunity to respond to Mr. Kupritz' charges. Sony has consistently strived to build a reputation for quality, both in our products and in our business conduct. We have a 30 year history of significant investment in the United States. We employ approximately 15,000 Americans in our electronics, records, and motion picture operations. Thus, we have a vested interest in seeing a financially sound U.S. economy and would never shirk responsibility for our fair share of the tax burden.

Moreover, we are continually investing in our U.S. facilities, such as a recently completed addition to our San Diego plant of a 32" color television production line. This addition involved capital expenditures in excess of $100 million. In every country in which we operate, we strive not only to be successful in business, but to be a good corporate citizen as well, including full compliance with all applicable laws and regulations. Given these facts, Mr. Kupritz' charges are particularly repugnant.

I am pleased to have had this opportunity to respond to your concerns.

Very truly yours,

N Vander Dussen

N. Vander Dussen
President and
Chief Operating Officer

NVD:gmd

STATEMENT
on
THE TAX TREATMENT
OF FOREIGN INVESTMENT IN THE UNITED STATES
for submission to the
HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
for the
U.S. CHAMBER OF COMMERCE
by
Benson S. Goldstein*
July 30, 1990

The U.S. Chamber of Commerce is pleased to provide its views on transfer pricing and the tax treatment of foreign investment in the United States. This statement is filed in conjunction with the July 10 and 12, 1990 hearings held by the House Ways and Means Committee's Subcommittee on Oversight. These hearings are part of the subcommittee's focus on the compliance by foreign firms with the transfer pricing rules under Section 482 of the Internal Revenue Code.

Although ostensibly focussing on narrow compliance issues, the subcommittee must also take into account the broader policy issues which the Chamber feels warrant discussion at this hearing. First, it is the Chamber's belief that Section 482 and its underlying "arm's length standard", which mandates that if a taxpayer sells property to a related party he should set a transfer price at a level that an unrelated party would set under similar conditions, is sound tax policy. Second, the subcommittee's investigation must take into account the interrelationship of foreign investment in the United States with economic growth for the U.S. economy. Last, to the extent restrictive tax laws are passed affecting the U.S. subsidiaries of foreign corporations, foreign countries may decide to retaliate and pass similar measures which are likely to harm U.S. companies doing business overseas.

The Chamber strongly supports the notion that all corporations doing business in the U.S., whether domestic or foreign-owned, should pay their fair share of taxes to the U.S. Treasury. The current arms length transfer pricing rules are sound tax policy and Congress should be cautious in passing new laws which may only serve to accomplish arbitrary results and impede economic growth for the American economy.

Moreover, significant changes have been made in recent years in international tax--beginning with the 1986 Tax Reform Act and including major changes in last year's tax bill--and statistical data is still not available to draw conclusions about the impact these changes have had on the level of taxation of foreign-owned companies doing business in the United States.

IRS Statistics and Foreign Investment

Recently, there have been widespread press reports that the affiliates of foreign corporations have not been paying their fair share of taxes to the U.S. Treasury. These include published statements that foreign-owned companies had a negative tax liability of over $1 billion in 1986. A Washington Post article, dated June 29, 1990, stated that the reported income of Japanese-owned companies operating in the United States declined

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*Tax Attorney, Tax Policy Center

65% to $219 million in 1987, even though the income reported by all foreign-owned companies rose to $5.6 billion. Such statements have led to the introduction by Representative Rostenkowski and others of H.R. 4308, the Foreign Tax Equity Act of 1990. The provisions of H.R. 4308 are conceptually similar to several of the foreign tax proposals contained in the House Fiscal Year 1990 reconciliation bill of last year, some of which were included in the final legislation by the House-Senate conference committee.

The statistics that have been released to date have been quickly seized by the media, with apparent misinterpretation of the meaning and implications of those statistics. It is clear that all businesses should pay their fair share of taxes to the U.S. Treasury. Nevertheless, caution must be expressed against drawing conclusions from statistics which do not provide any clear indication of abuse.

According to a study released on June 8, 1990 and prepared by KPMG Peat Marwick, all foreign-controlled domestic corporations combined reported a minus $1.5 billion in pretax net income in 1986--a decline from of $3.0 billion in 1985. The media has reported the minus $1.5 billion statistic out of context, particularly by excluding the fact that profitable foreign-controlled corporations still showed a tax liability of $3 billion in U.S. taxes in 1986. The KPMG study also indicated that the average effective U.S. tax rate on profitable foreign-controlled domestic corporations was significantly above all other corporations in the U.S. between 1983 and 1986.

Misinterpretation of IRS data regarding the U.S. subsidiaries of foreign corporations can have several causes. The KPMG analysis suggests that publicly available tax return data do not provide information completely explaining the reason for the reduction in net income by foreign-controlled domestic corporations. For example, there is insufficient information on expense items such as interest and depreciation, often major costs associated with the start-up of a new U.S. plant. There is also the question of the impact of the decline in the value of the dollar on the tax reporting of foreign-owned firms in the United States.

In other words, such analysis cannot be accomplished by simply referring to IRS statistics from 1986 or 1987. Furthermore, it should be emphasized that the Omnibus Budget Reconciliation Act of 1989 (1989 Act) includes several provisions affecting the taxation of foreign firms operating in the United States, including a measure designed to address the so-called earnings stripping by a foreign parent of a U.S. affiliate as well as provision requiring increased information reporting by subsidiaries of foreign-based corporations. Another proposal included in the House reconciliation bill, but later dropped by the House-Senate conference committee, would have imposed a capital gains tax on the disposition of stock held by certain foreign shareholders in U.S. companies.

The Chamber expressed concern about these proposals during the 1989 budget reconciliation debate due to their potential for impeding free trade and investment. For this reason, we believe it would be best to evaluate the impact of the 1989 tax provisions on overall federal tax receipts before passing further restrictions in the tax law with respect to foreign investment in the United States.

The Arm's Length Standard and Section 482

The Chamber views the arm's length principle for transfer pricing to be sound tax policy. Underlying Section 482 is the notion of horizontal equity. Horizontal equity means that taxpayers with equivalent income should pay similar levels of tax. The policy objective of horizontal equity is achieved through the implementation of the arm's length standard of the regulations.

Section 482 provides the IRS the authority to reallocate income or deductions between members of a consolidated group, while leaving the total income of the group unchanged. The thrust of this subcommittee's present investigation is whether a foreign parent corporation is artificially charging its U.S. subsidiary a high price for services or goods it provides to the subsidiary. To the extent an artificially high price has been set by the parent corporation, the IRS can use Section 482 to reallocate income to the U.S. subsidiary, resulting in more tax paid to the U.S.

From a tax compliance perspective, the arm's length standard of Section 482 is the best mechanism for assuring that both U.S. multinational corporations and foreign corporations doing business in the United States pay their fair share of taxes to the U.S. Treasury.

In the Treasury Department's 1988 "White Paper" on intercompany pricing, Stanley Surrey is quoted in defense of the arm's length method: "Presumably, most transactions are governed by the general framework of the marketplace and hence it is appropriate to seek to put intra-group transactions under that general framework. Thus, use of the standard of arm's length, both to test the actual allocation of income and expense resulting under controlled intra-group arrangements and to adjust that allocation if it does not meet such standard, appears in theory to be a proper course."

The arm's length principle assures that taxpayers are free to arrange their transactions in any manner based on legitimate business practices within the context of a free market system. Moreover, the arm's length standard provides the U.S. Treasury with the proper tools to address transactions between related parties which represent an evasion of taxes or which do not clearly reflect income.

The Arm's Length Standard Internationally

The arm's length standard for transfer pricing was adopted by the U.S. Treasury in 1934. Since then, it has become the standard for transfer pricing rules among industrialized nations. This is evidenced by its adoption by the Organization for Economic Cooperation and Development (OECD) as a world model. OECD has urged uniformity in transfer pricing rules on the model of the arm's length standard, as that principle is the best means of mitigating double taxation of a U.S. or foreign corporation's income on an international basis. OECD adoption of the arm's length rule is due in large part to the influence of the United States.

Although not included as a provision in the Foreign Tax Equity Act, Representative Rostenkowski might support the establishment of a rebuttable presumption rule for limiting transfer prices in certain foreign-related transactions. In his remarks accompanying the introduction of H.R. 4308, Representative Rostenkowski stated that "in determining the taxable income of a U.S. corporation from the sales of property acquired from a foreign person, a transfer price would be used that results in the U.S. corporation having taxable income from the sale of **not less than 50%** of the combined taxable income of the U.S. corporation and any related person from such party, **unless the taxpayer proves otherwise to the satisfaction of the Secretary of the Treasury.**" (Emphasis added.) A formulary method, such as along the lines of Representative Rostenkowski's 50/50 rebuttable presumption, is likely to lead to arbitrary results. Any transfer pricing method not based on the arm's length principle may end up allocating more income to U.S. sources than foreign jurisdictions might permit. To the extent foreign countries continue to utilize the arm's length principle for transfer prices, the arbitrariness of the 50/50 formula is likely to lead to double taxation for multinational corporations.

U.S. tax laws must take a world view. The United States should not adopt arbitrary transfer pricing rules for purposes of Section 482. Such changes are likely to end up harming U.S. business interests overseas and lead to decreased growth of the American economy.

Increased Information Reporting and Penalty Rules

The 1989 Act expands the information reporting requirements of Section 6038A to cover U.S. corporations at least 25 percent owned by a foreign shareholder. The 1989 Act also requires the maintenance of books and records in a location and manner, and to the extent prescribed by regulation, considered appropriate for review of transactions with related persons. Although records would normally be required to be maintained in the U.S., the Treasury Department would be permitted to allow records to be maintained outside the United States in cases where it is satisfied such records would be submitted to the IRS "promptly upon request." Moreover, the provision increases the penalties for failure to meet the requirements of Section 6038A, and it imposes substantial enforcement rules regarding such information requests.

The information reporting requirements of the 1989 Act directly impact the U.S. subsidiaries of foreign corporations, but do not subject U.S. branches of foreign corporations to the reporting rules. By extending the scope of last year's law retroactively to cover ongoing IRS audits and imposing the reporting rules on U.S. branches of foreign companies, the Foreign Tax Equity Act would further broaden the coverage of 1989 law.

The Chamber expressed concern about the information reporting rules of the 1989 Act. Proposals of this type might become intrusive and burdensome to foreign investors in the United States, and could be viewed as violative of U.S. tax treaties with other nations. Imposing increased information-reporting rules on foreign corporations doing business in the United States may trigger retaliation by foreign countries against American companies selling goods or services in those countries. This could damage the competitiveness of American business interests, particularly if these countries do not subject their tax collection agencies to rules such as those currently imposed on the IRS regarding confidentiality and prohibitions against disclosing taxpayer information.

If there is a compelling rationale for the reporting rules of the 1989 Act, or for expanding those rules, the matter would be more prudently addressed by bilateral discussions between the U.S. and foreign governments.

The New Frontier in Tax Compliance--Extension of the Assessment Period

Under current law, the IRS is generally required to examine a tax return and assess a deficiency of tax within three years after the filing of the tax return. Extension of this general three-year statute of limitations could follow from situations such as fraud or intention to evade tax. Moreover, the taxpayer and the IRS may mutually agree to extend the assessment period.

The general statute of limitations for nonfraud-related tax cases has traditionally been maintained at three years to protect the personal rights of taxpayers and to ensure they cannot indefinitely be subject to uncertainty and potential harassment by the government.

Unfortunately, there appears to be an effort underway to extend systematically the period of assessment to six years after the filing of a tax return. For example, the Foreign Tax Equity Act of 1990 would provide the Secretary of the Treasury with the authority to extend the assessment period to six years regarding a deficiency involving a transaction between a U.S. affiliate and its foreign parent.

As another example, the House Ways and Means Committee discussion draft to modify Section 2036(c) also contains an extension of the statute of limitations. This proposal would generally extend the gift tax statute of limitations from three years to six years for transfers subject to the provisions of the draft legislation. Further, the statute of limitations would be unlimited for transfers subject to the legislation but which have not been reported.

The Chamber fears that once Congress starts down the path of instituting a six-year tax assessment period for certain taxpayers or transactions, the precedent and the policy rationale will have been set for extending the six-year statute of limitations to all taxpayers and all transactions.

In all likelihood, an extension of the assessment period will not do anything significant to address the so-called tax gap or tax compliance problems. If the IRS cannot sufficiently audit returns within three years of when a tax return is filed, it is unlikely to be able to audit such returns within a six-year period. More likely, an extension of the assessment period will merely allow the IRS to postpone critical decisions about pending tax cases. To the extent that there is a backlog of tax cases that must be reviewed by the IRS, there is a high probability that this backlog would grow and not decline.

But the real cost to taxpayers of a six-year statute of limitations is the cost associated with keeping books and records for longer periods of time, the loss of key personnel familiar with the underlying transaction, the significant loss of personal rights, and the uncertainty associated with doubling the number of open audit years.

Capital Gains Tax on Foreign Investors

The House-Senate conferees did not include an earlier House proposal in the final 1989 Act, which would have otherwise subjected certain foreign investors to a capital gains tax in the United States on the disposition of stock they owned in a U.S. corporation. The proposal would have applied to a foreign person owning more than 10 percent of the stock in that U.S. corporation. The Foreign Tax Equity Act includes a similar provision, which has been modified to ensure that it does not override U.S. tax treaties with other nations. To the extent that the United States has a tax treaty with another country addressing the taxation of stock gains, the capital gains tax would not apply to the residents of those countries. Nevertheless, the capital gains tax would be imposed on investors in the United States from Great Britain, Australia and other nations due to the nature of the U.S. tax treaties with those nations.

The Chamber fears that a capital gains proposal like the one contained in the Foreign Tax Equity Act only invites retaliation by foreign countries against investment by U.S. residents overseas. In particular, the capital gains proposal is inconsistent with traditional notions of international taxation. It is well-settled international tax policy that gains on stock sales should generally be taxed only by the country of residence, not by the country of source.

Conclusion

Although the subcommittee hearing focuses on tax compliance issues, the subcommittee must not lose sight of the interrelationship of the hearing topic to foreign investment flows and the need for a spirit of cooperation between the United States and its trading partners. By imposing restrictive tax laws on foreign investors, the United States would be increasing the cost of capital in the United States. The Chamber believes that foreign investment in the U.S. often brings new technology and management techniques to the domestic market that can serve to enhance the economic competitiveness of U.S. business.

In the increasingly complex and interwoven international marketplace, competition for investment capital is growing more intense. Every dollar of foreign investment in the United States could have gone elsewhere. Every dollar invested in the United States improves the health of our economy and creates jobs for the nations' work force.

To the extent the U.S. enacts restrictive tax laws affecting foreign investors, foreign countries might view such laws as legislative overrides of U.S. tax treaties with these countries. The legislative override of tax treaties has become increasingly common since passage of the Tax Reform Act of 1986. This has been a major problem for U.S. business, particularly because it is coming at a time when there is increased pressure on U.S. corporations to improve their competitiveness through the sale of products and services on a global basis. An unwillingness to honor our international treaty obligations will have two effects. First, it will make foreign governments less willing to enter into mutually beneficial treaty arrangements and second, it will invite retaliation by foreign countries against U.S. business interests in those countries.

The issues regarding foreign investment are multifaceted and difficult. Changes in the law in the area of tax compliance can have pronounced effects on the cost of capital and international investment flows. The Chamber recommends that the committee carefully analyze these effects as it seeks ways to close the tax gap.

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